

United States
Court of Appeals
for the Ninth Circuit

JOHN K. NORTHROP, Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent,
and

INEZ H. NORTHROP, Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Transcript of Record

Petitions to Review Decisions of The Tax Court
of the United States

JOHN K. NORTHROP,Petitioner,
vs.
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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APPEARANCES

For Taxpayer:

MAYNARD J. TOLL, Esq.,
RUSSELL S. BOCK, Esq.,
SIDNEY N. WALL, Esq.,
GEORGE F. ELMENDORF, Esq.

For Commissioner:

R. E. MAIDEN, Esq.

Docket Nos. 5041-5042

JOHN K. NORTHROP,
INEZ H. NORTHROP,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1944

May 22—Petition received and filed. Taxpayer notified. Fee paid.

May 22—Request for Circuit hearing in Los Angeles filed by taxpayer. 5/27/44 granted.

May 23—Copy of petition served on General Counsel.

Jun. 24—Answer filed by General Counsel.

1944

Jun. 28—Copy of answer served on taxpayer—Los Angeles, Calif.

1946

Jan. 16—Notice calendar call Feb. 11, 1946, at Los Angeles, Calif.

Mar. 1—Transcript of hearing of Feb. 11, 1946, filed. Case remains on Los Angeles Calendar.

Sep. 11—Hearing set November 4, 1946, at Los Angeles, Calif.

Nov. 12, 13—Hearing had before Judge Hill on merits. Motion of counsel to consolidate dockets 5039 to 5046 inclusive granted. Stipulation of facts filed. Entry of appearance of Sidney N. Wall and George F. Elmendorf as counsel filed at hearing. Briefs due Dec. 30, 1946—replies Jan. 29, 1947.

Dec. 17—Motion for extension to Jan. 16, 1947, to file opening briefs and Feb. 15, 1947, to file reply briefs filed by both parties. 12/18/46 granted.

1947

Jan. 14—Motion for extension to Feb. 3, 1947, to file briefs and March 5, 1947, to file reply briefs filed by General Counsel. 1/15/47 granted.

Jan. 30—Brief filed by taxpayer.

Feb. 3—Brief filed by General Counsel.

1947

Feb. 20—Motion for extension to March 20, 1947, to file reply brief filed by taxpayer. Granted.

Mar. 19—Reply brief filed by taxpayer. 3/19/47 copy served.

Mar. 20—Memorandum reply brief filed by General Counsel.

Apr. 9—Findings of fact and opinion rendered, Hill J. Decision will be entered under Rule 50. 4/10/47 copy served.

May 5—Motion for review by the Full Court filed by taxpayer. 5/8/47 denied.

Jun. 11—Computation for entry of decision filed by General Counsel.

Jun. 16—Hearing set July 16, 1947, at Washington, D. C., under Rule 50.

Jun. 16—Consent to settlement filed by taxpayer. [1]

Jun. 18—Decision entered, Hill J. Div. 2.

Sep. 15—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, filed by taxpayer.

Sep. 25—Proof of service filed.

Sep. 29—Application for consolidation of causes (Docket 5041-42) for the purpose of sending up a single consolidated record on review—with endorsement from the Circuit Court thereon and affidavit of service filed.

1947

- Sep. 29—Application for transmittal of original exhibits from Tax Court with endorsement from Circuit Court thereon and affidavit of service thereon filed.
- Sep. 29—Notice of granting of application for consolidation of causes and of application for transmittal of original exhibits from the Tax Court filed by taxpayer with affidavit of service thereon.
- Oct. 20—Statement of points with affidavit of service by mail thereon filed by taxpayer.
- Oct. 20—Designation of record with affidavit of service by mail thereon filed by taxpayer.
- Oct. 31—Notice granting of application for extension of time for transmitting record on review for 30 days filed by taxpayer with affidavit of service thereon.
- Nov. 3—Certified copy of order from 9th Circuit granting application for extension of 30 days for transmitting record on review filed. [2*]

* Page numbering appearing at foot of page of original certified Transcript of Record.

The Tax Court of the United States

Docket No. 5041

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (LA:IT:90D:PAK) dated February 24, 1944, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual with residence at 3750 West Crestway Drive, Los Angeles 43, California. The return for the period here involved was filed with the Collector for the Sixth District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was presumably mailed to the petitioner on February 24, 1944. [5]

3. The tax in controversy is income tax for the calendar year 1940, in the amount of \$99,479.05, which is the total deficiency asserted by the Commissioner.

Assignment of Error

4. The determination as set forth in the said notice of deficiency is based upon the following error:

(a) The Commissioner erred in including in petitioner's income for 1940 the amount of \$168,265.63 as petitioner's community one-half of the "fair market value" of 15,384 shares of Class A stock and 38,461 shares of Class B stock of Northrop Aircraft, Inc., said to have been received by the petitioner in 1940 as compensation for services rendered in connection with the organization of that corporation.

Facts

5. The facts upon which petitioner relies as a basis of this proceeding are as follows:

(a) The petitioner was one of the promoters of Northrop Aircraft, Inc., a California corporation engaged in the manufacture of aircraft, and has been the president and a director of the corporation since its inception. He is a well-known aircraft engineer and designer.

(b) Northrop Aircraft, Inc., was incorporated under the laws of California on March 7, 1939. On June 15, 1939, the California Corporation Commissioner issued a permit authorizing [6] the company to sell and issue certain of its securities, including the Class A Common and Class B Common shares referred to hereinafter.

(c) On June 17, 1939, petitioner entered into an agreement with Northrop Aircraft, Inc., whereby the latter was to issue to him not exceeding 24,615 shares

of Class A Common Stock and 61,538 shares of Class B Common Stock in consideration for the use of his name, his past promotional services and his entering into a contract whereby he was to be employed by the company for a term of five years as the person in charge of engineering and design. The agreement provided that petitioner was to become entitled to Class A and Class B shares as Class A shares were sold to the public for cash and in proportion to such sales as follows:

One Class A share for each 16.25 Class A shares sold for cash

One Class B share for each 6.5 Class A shares sold for cash

Said agreement further provided that 60% of the Class B shares issued to petitioner should be subject to an option in favor of the company at twenty-five cents per share, conditioned upon the death of petitioner or his discharge for cause prior to the expiration of the five-year employment contract. The agreement further provided for a release of one-third of these optioned shares at the end of each of the last three years of a five-year period beginning August 1, 1939. Sixty per cent of Class B shares received by petitioner amounted to approximately 23,077 shares.

(d) Following is a schedule showing the dates on which stock was sold by Northrop Aircraft, Inc., for cash, and the amounts of stock to which petitioner became entitled on such dates in accordance with the agreement described above:

Stock Issuance

	Class A	Class B
1939		
7-21	4,415	11,037
7-24	113	283
7-31	1,933	4,833
8-15	123	307
8-23	153	384
8-28	201	504
8-29	123	307
8-30	798	1,995
9-11	153	384
9-12	246	615
9-20	307	769
9-28	659	1,649
9-29	771	1,927
10- 3	307	769
10-24	53	133
10-27	511	1,278
10-28	461	1,153
11- 1	615	1,538
11- 6	769	1,923
11- 8	769	1,923
11- 9	461	1,153
11-13	307	769
11-15	153	384
11-27	107	269
11-28	865	2,164
11-28	Adjustment for fractional shares	11
	<hr/> 15,384	<hr/> 38,461

(e) The Corporation Commissioner's permit authorizing issuance of shares provided that all certificates evidencing any of the shares issued to petitioner (and other promoters) should be deposited with an escrow holder, to be held [8] by such holder until an order for release was given in writing by the Commissioner. The permit further provided that no sale or transfer of the stock held in escrow could be

made without the written consent of the Commissioner.

(f) The Corporation Commissioner's permit further required as a condition of the issuance of shares to petitioner that he (with other promoters) agree as owner of Class A and Class B shares to waive his right to participate in any distribution of assets of Northrop Aircraft, Inc., while the stock was in escrow, until all shareholders who had paid cash or the equivalent for their stock had received the return of the full amount of the issuance price.

(g) The Corporation Commissioner's permit further required as a condition of issuance of shares to petitioner that he (with other promoters) agree as owner of Class A and Class B shares to waive his right to the payment or accrual of any dividends while the shares were in escrow.

(h) It is customary for the California Corporation Commissioner to require stock issued for promotional services or similar consideration in speculative enterprises to be placed in escrow and held there until such time as the corporation's business and financial position have become reasonably well established.

(i) Neither the Class A shares nor the Class B shares to which this proceeding relates had any fair market value at any time during the year 1940. [9]

(j) Petitioner's returns are filed on the basis of cash receipts and disbursements.

(k) The certificates evidencing title to petitioner's shares amounting to 15,384 of Class A and 38,461 of Class B were issued in his name on March 4, 1940,

and placed in escrow with the Bank of America, Los Angeles, California, on the same day.

(1) The Class A shares issued by Northrop Aircraft, Inc., had the full rights ordinarily attributable to common shares, and were designated Class A to distinguish them from the Class B shares, which had a secondary status in relation to the Class A shares. Under the articles of incorporation, the Class B shares were to become convertible to Class A shares if a specified amount of profits was earned during a period of five years from August 1, 1939. Said Class B shares did not become so convertible during 1940. None of the shares issued to petitioner were released from escrow in 1940 except 5,240 Class A shares which were so released on November 19, 1940.

(m) Upon examination of petitioner's 1940 return the Commissioner added to income an amount of \$168,265.63 representing petitioner's community one-half of the claimed value of 15,384 shares of Class A stock and 38,461 shares of Class B stock, all priced at \$6.25 per share. [10]

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that

(A) Petitioner realized no income in 1940 from receipt of stock of Northrop Aircraft, Inc.

(B) There is no deficiency due from petitioner for the year 1940.

/s/ MAYNARD J. TOLL,

/s/ RUSSELL S. BOCK,

Counsel for Petitioner. [11]

State of California,
County of Los Angeles—ss.

John K. Northrop, being duly sworn, says that he is the petitioner above named; that he has read the foregoing petition, or has had the same read to him, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts he believes to be true.

/s/ JOHN K. NORTHROP.

Subscribed and sworn to before me this 13th day of May, 1944.

(Seal) /s/ MARGARET C. BATEMAN,
Notary Public in and for the County of Los Angeles,
State of California.

My commission expires August 13th, 1947.

I hereby certify that the foregoing is a true copy of the petition to The Tax Court of the United States signed by me on May 16, 1944.

/s/ MAYNARD J. TOLL,
Counsel for Petitioner. [12]

EXHIBIT "A"

Treasury Department
Internal Revenue Service
417 South Hill Street
Los Angeles 13, California

Office of
Internal Revenue Agent in Charge
Los Angeles Division

LA:IT:90D:PAK

February 24, 1944

Mr. John K. Northrop
3750 West Crestway Drive
Los Angeles, California

Dear Mr. Northrop:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1940, discloses a deficiency of \$99,479.05 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are re-

requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of LA:Conf. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

HAROLD N. GRAVES,
Acting Commissioner,

By GEORGE D. MARTIN,
Internal Revenue Agent in Charge.

Enclosures: Statement; Form of waiver. [13]

STATEMENT

LA:IT:90D:PAK

Mr. John K. Northrop,
3750 West Crestway Drive, Los Angeles, Calif.

Tax Liability for the Taxable Year Ended December 31, 1940

Year	Liability	Assessed	Deficiency
1940	\$101,041.53	\$1,562.48	\$99,479.05

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated April 30, 1942, and April 30, 1943, to your protest dated July 15, 1943, and to the statements made at conferences held on November 5, 1943, and December 20, 1943.

A copy of this letter and statement has been mailed to your representative, Mr. Russell S. Bock, 548 South Spring Street, Los Angeles, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustment to Net Income

Net income as disclosed by return.....	\$ 13,002.24
Additional income and unallowable deductions:	
(a) Fair market value of stock received as compensation	168,265.63
(b) Legal expense	482.75
(c) Adjustment of dividends from Northhill Company, Inc.	2,745.28
<hr/>	
Total	\$184,495.90
Additional deduction:	
(d) Loss on worthless stock.....	1,252.50
<hr/>	
Net income adjusted	\$183,243.40

Explanations of Adjustments

(a) During the taxable year 1940 you received 15,384 shares of Class A stock and 38,461 shares of Class B stock of Northrop Aircraft, Inc., as compensation for services rendered in connection with the organization of that corporation. It has been determined that each class of stock had a fair market value of \$6.25 per share when received by you.

Accordingly, there is added to your income the amount of \$168,265.63 representing one-half of the fair market value of the shares of stock received by you, taxable as community income, and computed as follows:

15,384 shares of Class A stock at \$6.25 per share.....	\$ 96,150.00
38,461 shares of Class B stock at \$6.25 per share.....	240,381.25
<hr/>	
Total	\$336,531.25
One-half added to your income.....	\$168,265.63

(b) Legal expense of \$482.75 has not been substantiated as being a proper deduction under section 23(a) of the Internal Revenue Code.

(c) The amount of taxable dividends received from the Northill Company, Inc., has been increased from \$1,047.80 reported by you to the correct amount of \$3,793.08.

(d) A loss of \$1,252.50 is allowable upon your investment in the capital stock of Air Balance Instrument Company becoming worthless during the taxable year.

Computation of Alternative Tax

Net income adjusted	\$183,243.40
Plus: Net long-term capital loss.....	24.00
<hr/>	
Ordinary net income	\$183,267.40
Less: Personal exemption	\$ 200.00
Credit for dependents	1,600.00 1,800.00
<hr/>	
Balance (surtax net income).....	\$181,467.40
Less: Earned income credit	1,400.00
<hr/>	
Net income subject to normal tax.....	\$180,067.40
Normal tax at 4% on \$180,067.40.....	\$ 7,202.70
Surtax on \$181,467.40	84,660.44
<hr/>	
Partial tax	\$ 91,863.14
Minus: 30% of net long-term capital loss....	7.20
<hr/>	
Alternative tax	\$ 91,855.94

Computation of Tax

Net Income Adjusted		\$183,243.40
Less: Personal exemption	\$ 200.00	
Credit for dependents	1,600.00	1,800.00
		<hr/>
Balance (surtax net income)		\$181,443.40
Less: Earned income credit		
(10% of \$14,000.00)		1,400.00
		<hr/>
Net income subject to normal tax		\$180,043.40
Normal tax at 4% on \$180,043.40	\$ 7,201.74	
Surtax on \$181,443.40	84,646.03	
		<hr/>
Total normal tax and surtax		\$ 91,847.77
Alternative tax		\$ 91,855.94
Defense tax (10% of \$97,855.93)		9,185.59
		<hr/>
Total income tax		\$101,041.53
Correct income tax liability		\$101,041.53
Income tax assessed:		
Original, account No. 203981	\$ 997.70	
Additional, July, 1942, 510116	564.78	
		<hr/>
Total income tax assessed		1,562.48
		<hr/>
Deficiency of income tax		\$ 99,479.05

[Endorsed]: T.C.U.S. Filed May 22, 1944.

[Title of Tax Court and Cause.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits that the notice of deficiency involved herein was mailed to the petitioner on February 24, 1944.

3. Admits that the tax in controversy is income tax for the calendar year 1940; denies the remaining allegations contained in paragraph 3 of the petition.

4. Denies the allegations of error contained in subparagraph (a) of paragraph 4 of the petition.

5. (a) to (j), inclusive. Denies the allegations contained [17] in subparagraphs (a) to (j), inclusive, of paragraph 5 of the petition.

(k) Admits the allegations contained in subparagraph (k) of paragraph 5 of the petition.

(l) Denies the allegations contained in subparagraph (l) of paragraph 5 of the petition.

(m) Admits the allegations contained in subparagraph (m) of paragraph 5 of the petition.

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ J. P. WENCHEL,
Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,
Division Counsel.

EARL C. CROUTER,
Special Attorney, Bureau of Internal Revenue

[Endorsed]: T.C.U.S. Filed June 24, 1944. [18]

[Title of Tax Court and Cause No. 5042.]

PETITION

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (LA:IT:90D:PAK) dated February 24, 1944, and as a basis of her proceeding alleges as follows:

1. The petitioner is an individual with residence at 3750 West Crestway Drive, Los Angeles 43, California. The return for the period here involved was filed with the Collector for the Sixth District of California.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was presumably mailed to the petitioner on February 24, 1944. [19]

3. The tax in controversy is income tax for the calendar year 1940, in the amount of \$99,479.04, which is the total deficiency asserted by the Commissioner.

Assignment of Error

4. The determination as set forth in the said notice of deficiency is based upon the following error:

(a) The Commissioner erred in including in petitioner's income for 1940 the amount of \$168,265.62 as petitioner's community one-half of the "fair market value" of 15,384 shares of Class A stock and 38,461 shares of Class B stock of Northrop Aircraft, Inc., said to have been received by the petitioner's

husband in 1940 as compensation for services rendered in connection with the organization of that corporation.

Facts

5. The facts upon which petitioner relies as a basis of this proceeding are as follows:

(a) The petitioner's husband was one of the promoters of Northrop Aircraft, Inc., a California corporation engaged in the manufacture of aircraft, and has been the president and a director of the corporation since its inception. He is a well-known aircraft engineer and designer.

(b) Northrop Aircraft, Inc., was incorporated under the laws of California on March 7, 1939. On June 15, 1939, [20] the California Corporation Commissioner issued a permit authorizing the company to sell and issue certain of its securities, including the Class A Common and Class B Common shares referred to hereinafter.

(c) On June 17, 1939, petitioner's husband entered into an agreement with Northrop Aircraft, Inc., whereby the latter was to issue to him not exceeding 24,615 shares of Class A Common Stock and 61,538 shares of Class B Common Stock in consideration for the use of his name, his past promotional services, and his entering into a contract whereby he was to be employed by the company for a term of five years as the person in charge of engineering and design. The agreement provided that petitioner's husband was to become entitled to Class A and Class

B shares as Class A shares were sold to the public for cash and in proportion to such sales as follows:

One Class A share for each 16.25 Class A shares sold for cash

One Class B share for each 6.5 Class A shares sold for cash

Said agreement further provided that 60% of the Class B shares issued to petitioner's husband should be subject to an option in favor of the company at twenty-five cents per share, conditioned upon the death of petitioner's husband or his discharge for cause prior to the expiration of the five-year employment contract. The agreement further provided for a release of one-third of these optioned shares at the end of each of the last three years of a five-year period beginning August 1, 1939. Sixty per cent of Class B shares received by petitioner's husband amounted to approximately 23,077 shares. [21]

(d) Following is a schedule showing the dates on which stock was sold by Northrop Aircraft, Inc., for cash, and the amounts of stock to which petitioner's husband became entitled on such dates in accordance with the agreement described above:

Stock Issuance

	Class A	Class B
1939		
7-21	4,415	11,037
7-24	113	283
7-31	1,933	4,833
8-15	123	307
8-23	153	384
8-28	201	504
8-29	123	307
8-30	798	1,995

Stock Issuance

	Class A	Class B
1939		
9-11	153	384
9-12	246	615
9-20	307	769
9-28	659	1,649
9-29	771	1,927
10- 3	307	769
10-24	53	133
10-27	511	1,278
10-28	461	1,153
11- 1	615	1,538
11- 6	769	1,923
11- 8	769	1,923
11- 9	461	1,153
11-13	307	769
11-15	153	384
11-27	107	269
11-28	865	2,164
11-28 Adjustment for fractional shares	11	11
	<hr/>	<hr/>
	15,384	38,461

(e) The Corporation Commissioner's permit authorizing issuance of shares provided that all certificates evidencing any of the shares issued to petitioner's husband (and other promoters) should be deposited with an escrow holder, to [22] be held by such holder until an order for release was given in writing by the Commissioner. The permit further provided that no sale or transfer of the stock held in escrow could be made without the written consent of the Commissioner.

(f) The Corporation Commissioner's permit further required as a condition of the issuance of shares to petitioner's husband that he (with other promoters) agree as owner of Class A and Class B shares

to waive his right to participate in any distribution of assets of Northrop Aircraft, Inc., while the stock was in escrow, until all shareholders who had paid cash or the equivalent for their stock had received the return of the full amount of the issuance price.

(g) The Corporation Commissioner's permit further required as a condition of issuance of shares to petitioner's husband that he (with other promoters) agree as owner of Class A and Class B shares to waive his right to the payment or accrual of any dividends while the shares were in escrow.

(h) It is customary for the California Corporation Commissioner to require stock issued for promotional services or similar consideration in speculative enterprises to be placed in escrow and held there until such time as the corporation's business and financial position have become reasonably well established.

(i) Neither the Class A shares nor the Class B shares to which this proceeding relates had any fair market value at any time during the year 1940. [23]

(j) Petitioner's returns are filed on the basis of cash receipts and disbursements.

(k) The certificates evidencing title to petitioner's husband's shares amounting to 15,384 of Class A and 38,461 of Class B were issued in his name on March 4, 1940, and placed in escrow with the Bank of America, Los Angeles, California, on the same day.

(l) The Class A shares issued by Northrop Aircraft, Inc., had the full rights ordinarily attributable

to common shares, and were designated Class A to distinguish them from the Class B shares, which had a secondary status in relation to the Class A shares. Under the articles of incorporation, the Class B shares were to become convertible to Class A shares if a specified amount of profits was earned during a period of five years from August 1, 1939. Said Class B shares did not become so convertible during 1940. None of the shares issued to petitioner's husband were released from escrow in 1940 except 5,240 Class A shares which were so released on November 19, 1940.

(m) Upon examination of petitioner's 1940 return the Commissioner added to income an amount of \$168,265.62 representing petitioner's community one-half of the claimed value of 15,384 shares of Class A stock and 38,461 shares of Class B stock, all prices at \$6.25 per share. [24]

Wherefore, the petitioner prays that this Court may hear the proceeding and determine that

(A) Petitioner realized no income in 1940 from receipt of stock of Northrop Aircraft, Inc.

(B) There is no deficiency due from petitioner for the year 1940.

/s/ MAYNARD J. TOLL,

/s/ RUSSELL S. BOCK,

Counsel for petitioner. [25]

State of California,
County of Los Angeles—ss.

Inez H. Northrop, being duly sworn, says that she is the petitioner above named; that she has read the foregoing petition, or has had the same read to her, and is familiar with the statements contained therein, and that the facts stated are true, except as to those facts stated to be upon information and belief, and those facts she believes to be true.

/s/ INEZ H. NORTHROP.

Subscribed and sworn to before me this 13th day of May, 1944.

(Seal) /s/ MARGARET C. BATEMAN,
Notary Public in and for the County of Los Angeles,
State of California.

My commission expires August 13th, 1947.

I hereby certify that the foregoing is a true copy of the petition to The Tax Court of the United States signed by me on May 16, 1944.

/s/ MAYNARD J. TOLL,
Counsel for Petitioner. [26]

EXHIBIT "A"

Treasury Department
Internal Revenue Service
417 South Hill Street
Los Angeles 13, California

Office of Internal Revenue Agent in Charge
Los Angeles Division

LA :IT :90D :PAK

February 24, 1944

Mrs. Inez H. Northrop
3750 West Crestway Drive
Los Angeles, California

Dear Mrs. Northrop:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1940, discloses a deficiency of \$99,479.04 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it

to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of LA:Conf. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

HAROLD N. GRAVES,
Acting Commissioner,

By GEORGE D. MARTIN,
Internal Revenue Agent in
Charge.

Enclosures: Statement; Form of waiver. [27]

STATEMENT

LA:IT:90D:PAK

Mrs. Inez H. Northrop
3750 West Crestway Drive
Los Angeles, California

Tax Liability for the Taxable Year Ended December 31, 1940

Year	Liability	Assessed	Deficiency
1940	\$101,041.53	\$1,562.48	\$99,479.05

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated April 30, 1942, and April 30, 1943, to your protest dated July 15, 1943,

and to the statements made at the conferences held on November 5, 1943, and December 20, 1943.

A copy of this letter and statement has been mailed to your representative, Mr. Russell S. Bock, 548 South Spring Street, Los Angeles, California, in accordance with the authority contained in the power of attorney executed by you.

Adjustment to Net Income

Net income as disclosed by return.....	\$ 13,002.23
Additional income and unallowable deductions:	
(a) Fair market value of stock received as compensation	168,265.62
(b) Legal expense	482.75
(c) Adjustment of dividends from Northhill Company, Inc.	2,745.28
<hr/>	
Total	\$184,495.88
Additional deduction:	
(d) Loss on worthless stock.....	1,252.50
<hr/>	
Net income adjusted	\$183,243.38

Explanation of Adjustments

(a) During the taxable year 1940 you received 15,384 shares of Class A stock and 38,461 shares of Class B stock of Northrop Aircraft, Inc., a compensation for services rendered in connection with the organization of that corporation. It has been determined that each class of stock had a fair market value of \$6.25 per share when received by you.

Accordingly, there is added to your income the amount of \$168,265.62 representing one-half of the fair market value of the shares of stock received by you, taxable as community income, and computed as follows:

15,384 shares of Class A stock at \$6.25 per share.....	\$ 96,150.00
38,461 shares of Class B stock at \$6.25 per share.....	240,381.25
<hr/>	
Total	\$336,531.25
One-half added to your income.....	\$168,265.62

(b) Legal expense of \$482.75 has not been substantiated as being a proper deduction under section 23(a) of the Internal Revenue Code.

(c) The amount of taxable dividends received from the Northhill Company, Inc., has been increased from \$1,047.80 reported by you to the correct amount of \$3,793.08.

(d) A loss of \$1,252.50 is allowed upon your investment in the capital stock of Air Balance Instrument Company becoming worthless during the taxable year.

Computation of Alternative Tax

Net income adjusted	\$183,243.38
Plus: Net long-term capital loss.....	24.00
<hr/>	
Ordinary net income.....	\$183,267.38
Less: Personal exemption\$ 1,800.00	\$ 1,800.00
<hr/>	
Balance (surtax net income)	\$181,467.38
Less: Earned income credit	1,400.00
<hr/>	
Net income subject to normal tax.....	\$180,067.38
Normal tax at 4% on \$180,067.38.....	\$ 7,202.70
Surtax on \$181,467.38	84,660.43
<hr/>	
Partial tax	\$ 91,863.13
Minus: 30% of net long-term capital loss....	7.20
<hr/>	
Alternative tax	\$ 91,855.93

Computation of Tax

Net Income Adjusted	\$183,243.38
Less: Personal exemption\$ 1,800.00	\$ 1,800.00
	<hr/>
Balance (surtax net income)	\$181,443.38
Less: Earned income credit	
(10% of \$14,000.00)	1,400.00
	<hr/>
Net income subject to normal tax.....	\$180,043.38
Normal tax at 4% on \$180,043.38.....\$ 7,201.74	
Surtax on \$181,443.38	84,646.03
	<hr/>
Total normal tax and surtax	\$ 91,847.77
Alternative tax	\$ 91,855.93
Defense tax (10% of \$91,855.93).....	9,185.59
	<hr/>
Total income tax	\$101,041.52
Correct income tax liability.....	\$101,041.52
Income tax assessed:	
Original, account No. 203982.....\$ 997.70	
Additional, July, 1942, 510118....	564.78
	<hr/>
Total income tax assessed.....	1,562.48
	<hr/>
Deficiency of income tax.....	\$ 99,479.04

[Endorsed]: T.C.U.S. Filed May 22, 1944. [30]

[Title of Tax Court and Cause No. 5042.]

ANSWER

The Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits that the notice of deficiency involved herein was mailed to the petitioner on February 24, 1944.

3. Admits that the tax in controversy is income tax for the calendar year 1940; denies the remaining allegations contained in paragraph 3 of the petition.

4. Denies the allegations of error contained in subparagraph (a) of paragraph 4 of the petition.

5. (a) to (j), inclusive. Denies the allegations contained [31] in subparagraphs (a) to (j), inclusive, of paragraph 5 of the petition.

(k) Admits the allegations contained in subparagraph (k) of paragraph 5 of the petition.

(l) Denies the allegations contained in subparagraph (l) of paragraph 5 of the petition.

(m) Admits the allegations contained in subparagraph (m) of paragraph 5 of the petition.

6. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied.

Wherefore, it is prayed that the determination of the Commissioner be approved.

/s/ J. P. WENCHEL,

Chief Counsel, Bureau of
Internal Revenue.

Of Counsel:

B. H. NEBLETT,

Division Counsel.

EARL C. CROUTER,

Special Attorney, Bureau of
Internal Revenue.

[Endorsed]: T.C.U.S. Filed June 24, 1944. [32]

8 T. C. No. 89

The Tax Court of the United States

LaMotte T. Cohu, Petitioner, et al.¹ v. Commissioner
of Internal Revenue, Respondent.

Docket Nos. 5039, 5040, 5041, 5042, 5043, 5044, 5045,
5046.

Promulgated April 9, 1947.

1. On the facts, held, that petitioners realized income in 1940 rather than 1939 on account of certain promotional stock issued to them.

2. Value of promotional stock determined.

¹Proceedings of the following petitioners are consolidated herewith: Didi M. Cohu; John K. Northrop; Inez H. Northrop; Gage H. Irving; Eleanor Salisbury Irving; Edward A. Bellande and Molly Lamont Bellande; Moye W. Stephens and Inez B. Stephens.

3. Promotional stock issued to petitioner LaMotte T. Cohu, held to be community property.

Sidney H. Wall, Esq., and George F. Elmen-dorf, Esq., for the petitioners in Docket Nos. 5039 to 5045, inclusive.

Wesley G. LaFever, Esq., for the petitioners in Docket No. 5046.

R. E. Maiden, Jr., Esq., for the respondent.

Respondent determined deficiencies in petitioners' income taxes for the calendar year 1940 as follows:

Docket No.	Petitioner	Amount of Deficiency
5039	LaMotte T. Cohu	\$60,490.65
5040	Didi M. Cohu	22,047.92
5041	John K. Northrop	99,479.05
5042	Inez H. Northrop	99,479.04
5043	Gage H. Irving	15,694.14
5044	Eleanor Salisbury Irving	16,381.31
5045	Edward A. Bellande and Molly Lamont Bellande	5,833.34
5046	Moye W. Stephens and Inez B. Stephens	4,455.93

The principal question, common to all the cases here involved, is whether certain stock received by petitioners primarily for their promotional work constituted realization by them of income in 1939 or 1940 and, if in the latter year, the amount thereof. With respect to Docket Nos. 5039 and 5040, there is the question of whether the stock received by LaMotte T. Cohu is his separate property or constitutes community property. The returns of the petitioners for 1940 were filed on a cash and calendar year basis with the collector of internal revenue for the sixth district of Califor-

nia at Los Angeles. The cases were consolidated at the hearing. The facts which were stipulated are so found.

FINDINGS OF FACT

Petitioners John K. Northrop, Inez H. Northrop, Gage H. Irving, Eleanor Salisbury Irving, Edward A. Bellande, Molly Lamont Bellande, Moye W. Stephens and Inez B. Stephens are now and at all times material hereto were individuals residing in Los Angeles County, California.

Petitioners Inez H. Northrop, Eleanor Salisbury Irving, Molly Lamont Bellande and Inez B. Stephens are now and at all times material hereto were the respective wives of petitioners John K. Northrop, Gage H. Irving, Edward A. Bellande and Moye W. Stephens. [34]

Petitioners Lamotte T. Cohu and Didi M. Cohu are now and at all times material hereto were husband and wife, and are now residents of Los Angeles, California.

Petitioners John K. Northrop, Lamotte T. Cohu, Gage H. Irving, Edward A. Bellande, and Moye W. Stephens, together with T. T. Ellsworth, were the promoters of Northrop Aircraft, Inc., a California corporation, hereinafter referred to as the "Company." As used hereinafter the word petitioners, unless otherwise indicated, will refer to the above promoters, excepting T. T. Ellsworth.

The Company was incorporated under California law March 7, 1939, and was authorized to issue two classes of stock to be designated Class A com-

mon and Class B common. By separate contracts between the Company and petitioners, dated June 17, 1939, the Company agreed to issue certain Class A and Class B stock to petitioners. These contracts provided in substance as follows:

(a) **Shares Agreed to be Issued:** Under each of the contracts the Company agreed to issue to the promoter concerned Class A and Class B common shares not in excess of specified amounts, the number of shares to be issued to each to be determined upon the basis of a specified ratio to the number of Class A common shares thereafter sold to the public. The maximum numbers of Class A and Class B common shares issuable to the respective promoters under the contracts and the ratios between the number of Class A shares sold to the public and the numbers of Class A and Class B shares to be issued to the respective promoters were as follows: [35]

Promoter	Class A		Class B	
	Maximum	Ratio to A Shares Sold to Public	Maximum	Ratio to A Shares Sold to Public
Northrop	24.615	1 to 16.25	61.538	1 to 6.5
Cohu	12.308	1 to 32.5	18.462	1 to 21.667
Irving	7.385	1 to 51.165	17.231	1 to 23.214
Bellande	2.462	1 to 162.5	3.692	1 to 108.33
Stephens	2.462	1 to 162.5	3.692	1 to 108.33
Ellsworth	2.462	1 to 162.5	3.692	1 to 108.33

(b) **Time of Issuance:** Each of the contracts provided that as of the date the Company first received cash proceeds from the sale of its shares, and thereafter if and as the Company should issue shares for money or other specified considerations,

the Company should issue to the promoter concerned Class A and Class B common shares in the ratios specified above to the number of Class A common shares so issued to the public for cash or such other specified considerations. Each of the contracts provided that the promoter's "rights to shares hereunder shall be deemed to have accrued as of the date of sale of the shares which shall have determined his right thereto, * * * notwithstanding the date of actual issuance thereof to" the promoter.

(c) Consideration: Under the Northrop contract the Company agreed to issue the shares to Northrop in consideration for the use of his name, his past promotional services, and his agreement to be employed by the Company to take charge of engineering and designing for a period of five years at annual salary of \$9,000. The consideration under the Cohu and Irving contracts was past promotional services and agreements to be employed by the Company, in Cohu's case as general manager for five years [36] at an annual salary of \$9,000, and Irving's case as assistant general manager in charge of production for five years at an annual salary of \$6,750. In the contracts with Bellande, Stephens and Ellsworth, the consideration was past promotional services.

(d) Options: Under each of the contracts with Northrop, Cohu and Irving, the Company was granted an option to purchase 60 per cent of the Class B shares issued thereunder upon the happening of certain events at the cash price of 25

cents per share. The Northrop and Irving contracts provided that the option should be exercisable in the event of the death of the employee or in the event of the termination of his employment contract by reason of his default. The Cohu contract provided that the option should be exercisable in the event of his death or in the event of the termination of his employment contract by the Company either by reason of his default or at the Company's option without default. Under each of these three contracts 60 per cent of the Class B common shares were to remain subject to the option for a period of two years after a date determined to be August 1, 1939, after which period the shares were to be gradually released from the option over the succeeding three-year period.

On June 15, 1939, the California Commissioner of Corporations issued a permit to the Company to sell and issue securities. Paragraph 4 of this permit authorized the Company as follows:

4. To sell and issue an aggregate of 51,694 of its Class A Common shares and 108,307 of its Class B common shares to John K. Northrop, Lamotte T. Cohu, Gage H. Irving, Moye W. Stephens, Edward A. Bellande, and T. T. Ellsworth, in the manner and form, for the considerations, and in the proportions as related to the shares sold under paragraphs 1 and 2 hereof, as set forth in the application. [37]

The permit conditioned the issuance of promotional shares as follows:

(b) That none of the shares authorized by para-

graph 4 hereof shall be sold or issued unless and until the applicant first shall have selected an escrow holder and said escrow holder shall have been first approved in writing by the Commissioner of Corporations; that, when issued, all certificates evidencing any of said shares shall be forthwith deposited with said escrow holder, to be held as an escrow pending the further written order of the said Commissioner; that the receipt of said escrow holder for said certificates shall be filed with said Commissioner; and that the owner or persons entitled to said shares shall not consummate a sale or transfer of said shares, or any interest therein, until the written consent of said Commissioner shall have been obtained so to do.

(c) That none of the shares authorized by paragraph 4 hereof shall be sold or issued unless and until John K. Northrop, Lamotte T. Cohu, Gage H. Irving, Moye W. Stephens, Edward A. Bel-land, and T. T. Ellsworth shall have executed an agreement in writing with said applicant, and filed a copy thereof with the Commissioner of Corporations, whereby they shall in effect agree for themselves, their successors, administrators, and assigns, as owner of the Class A Common shares and the Class B Common shares herein authorized to be issued to them under paragraph 4 hereof, to waive their right to participate in any distribution of assets of the applicant (excepting dividends payable according to law), while said shares shall be required to be held in escrow, until all stockholders who have paid cash or its equivalent for their

shares shall have received the return of the full amount of the issuance price.

(d) That none of the shares authorized by paragraph 4 hereof shall be sold or issued unless and until John K. Northrop, Lamotte T. Cohn, Gage H. Irving, Moye W. Stephens, Edward A. Bellande, and T. T. Ellsworth shall have executed a written waiver, and filed a copy thereof with the Commissioner of Corporations, for and on behalf of themselves, their successors, administrators, and assigns, wherein they waive, as owners of the Class A Common shares and the Class B Common shares herein authorized to be issued to them under paragraph 4 hereof, their right to the payment or accrual of any dividends while said shares shall be required to be held in escrow. [38]

On or about January 4, 1940, petitioners entered into a written agreement with the Company dated as of November 30, 1939, by which the petitioners waived their respective rights to participate in any distribution of assets of the Company while the promotional shares were required to be held in escrow and for the same period of time waived their rights to the payment or accrual of any dividends. An executed counterpart of such agreement was filed by the Company with the Commissioner of Corporations on or about January 22, 1940. On January 25, 1940, the Commissioner of Corporations approved the agreement of and acceptance by the Bank of America National Trust & Savings Association as escrow agent.

Pursuant to the provisions of the agreements

dated June 17, 1939, and pursuant to the provisions of the Corporation Commissioner's permit dated June 15, 1939, the Company on March 4, 1940, issued certificates to Class A common shares and Class B common shares of the Company in the following names and in the following respective amounts:

Name	Class A	Class B
John K. Northrop	15.384	38.461
LaMotte T. Cohu	7.692	11.538
Gage H. Irving	4.615	10.769
Edward A. Bellande	1.538	2,307
Moye W. Stephens	1.538	2,307
A. H. Smith	1,538	2,307

All of these certificates were on the same day placed in escrow with Bank of America National Trust & Saving Association, Los Angeles, California.

On November 28, 1939, the following transaction was consummated through White, Wyeth & Co., a Los Angeles securities firm, acting as a principal; T. T. Ellsworth assigned to A. H. Smith, a resident of Houston, Texas, his [39] contract with the Company dated June 17, 1939; A. H. Smith delivered to White, Wyeth & Co. 2,500 shares of Duval Texas Sulphur Co., of which 2,200 shares were transferred to T. T. Ellsworth in exchange for his contract, and 300 shares were retained by White, Wyeth & Co. as its profit on the transaction.

On November 28, 1939, T. T. Ellsworth sold 600 such shares of Duval Texas Sulphur Co. at a price of $7\frac{1}{8}$, for which he received \$4,251 on November 29, 1939.

Ellsworth had made written application dated

November 16, 1939, to the Commissioner of Corporations requesting written consent to the sale and transfer to Smith of all Ellsworth's right, title and interest in and to his shares of stock to which he was entitled under the employment contract of June 17, 1939. This manner of accomplishing the transfer was apparently abandoned and on November 21, 1939, the Company requested the Commissioner of Corporations to amend their permit by substituting Smith for Ellsworth as one of the promoters to whom applicant might issue shares. Such amendment was granted November 28, 1939.

By application dated July 26, 1940, LaMotte T. Cohu requested the Commissioner of Corporations to issue an order consenting to the assignment by way of gift to the applicant's wife, Didi M. Cohu, of 5,769 Class B common shares of the Company and to each of applicant's three daughters, Anne T. Cohu, Renee Cohu and Marit Cohu, respectively, of 1,923 of the shares, all of such shares being then held in escrow pursuant to the Corporation Commissioner's permit dated June 15, 1939. The Corporation [40] Commissioner, by order dated July 31, 1940, consented to the transfer of the shares in accordance with the application upon the condition that the new certificates evidencing such shares be deposited with Bank of America National Trust & Savings Association and held in escrow in accordance with the conditions of the Corporation Commissioner's permit dated June 15, 1939, and upon the further condition that the old certificate or certificates be immediately cancelled.

By an order dated November 19, 1940, the Commissioner of Corporations ordered 11,000 of the Class A shares then held in escrow to be released from escrow to the following named persons and in the following respective amounts:

Name	Class A Shares Released
John K. Northrop	5,240
LaMotte T. Cohu	2,620
Gage H. Irving	1,580
Edward A. Bellande	520
Moye W. Stephens	520
A. H. Smith	520

The stock to which the petitioners became entitled, except for the 11,000 shares just mentioned above, was released from escrow by order of the Commissioner of Corporations on October 26, 1942.

Under the provisions of Article Five of the articles of incorporation of the Company as amended June 14, 1939, the Class B common shares of the Company were subject to the following limitations and conversion rights:

(a) Class B shares were not entitled to participate in dividends declared or paid prior to July 1, 1942 (that date and other dates hereinafter mentioned being determined under the provisions of the Articles in relation to the actual date when the Company first received cash proceeds from the sale of its Class A shares), and were [41] entitled to participate in dividends declared and paid thereafter only in the event that specified earnings requirements per Class A share had been met.

(b) In the event of liquidation, dissolution or winding up of the Company, the holders of Class B

shares were not entitled to receive any distribution unless and until the holders of all Class A shares then outstanding should have received an amount equal to the consideration received by the Company upon the original issuance thereof.

(c) The Class B shares were to become void if no adjusted net profits, as therein defined, were earned by the Company either during the five-year period commencing August 1, 1939, or during the three-year period commencing August 1, 1941.

(d) Class B shares were convertible, share for share, into Class A shares on August 1, 1944, if adjusted net profits, as therein defined, had then amounted to 50c per Class A share per annum for the five-year period commencing August 1, 1939, based on a computation of such adjusted net profits either for the entire five-year period or for the three-year period commencing August 1, 1941. If such earnings per Class A share amounted to less than 50c per annum for such five-year period, then the Class B shares were convertible into a proportionately smaller number of Class A shares. Class B shares were further convertible, share for share, into Class A shares at any time prior to August 1, 1944, when the adjusted net profits, as therein defined, computed either from August 1, 1939, or from August 1, 1941, amounted in total to \$1,000,000.

None of the Company's Class B shares became convertible into Class A shares prior to August 1, 1942, nor were any of the Class B shares converted into Class A shares prior to August 1, 1942. On

August 1, 1942, pursuant to the provisions of Article Five (c)(1) of the articles of incorporation, all Class B shares became convertible, share for share, into Class A shares, by reason of the fact that the Company's adjusted net profits, as defined in Article Five (a)(4), computed from August 1, 1941, amounted to more than \$1,000,000. [42]

The Company and certain underwriters made and entered into an underwriting agreement dated June 17, 1939, pursuant to which the several underwriters named in the agreement agreed to purchase and the Company agreed to sell 200,000 of its Class A common shares in units of five shares and one public warrant at the price of \$25 per unit. Such agreement further provided for the employment of the several underwriters as exclusive agents of the Company for the offering and sale of an additional 200,000 of the Company's Class A common shares in units of five shares and one public warrant, and for the payment by the Company to each underwriter of a commission of \$1 per share on all shares of such stock sold by such underwriter as agent. The initial public offering price for the 200,000 underwritten shares and the 200,000 additional agency shares was specified in the underwriting agreement as \$30 per unit of five shares and one public warrant. As additional consideration to the underwriters, the agreement provided for the delivery by the Company to the underwriters of "underwriters' warrants" for the purchase of an aggregate of 53,333 shares of the Class A common stock, exercisable during the period of five years

at the price of \$7 per share or 80 per cent of book value, whichever was higher.

Before the public offering of the Company's Class A stock was commenced, two members of the original underwriting group withdrew and Lester & Co. was requested to and did become a member of the underwriting group. At least one other securities firm, Bateman, Eichler & Co., was approached with a proposition that it become a member of the underwriting group, but [43] that firm declined to participate in the underwriting or sale of the Class A stock to the public because it considered the stock too speculative to sell to its clients.

The Company first received cash proceeds from the sale of its shares on July 21, 1939, when the underwriters accepted and paid for in cash the first block of the underwritten Class A common shares which were offered to the public.

Difficulty in marketing the Class A stock to the public was encountered shortly after the public offering was commenced, and the shares were not well received by the public, with the result that only a very small amount of stock had been sold or subscribed for after 10 days or 2 weeks of trading.

In an effort to bolster public confidence in the stock by having an initiated investor take a substantial interest therein, the underwriters persuaded Floyd B. Odlum, president of Atlas Corporation and a personal friend of John K. Northrop, to subscribe in August, 1939, on behalf of Atlas Corporation for 30,000 shares of Class A stock and 6,000

public warrants (6,000 underwritten units). The units were purchased by Atlas Corporation and sold by the underwriters at the underwriters' cost of \$25 per unit, in order to stimulate the sale of shares to the public.

After the underwriters had disposed of between 200,000 and 225,000 shares of Class A common stock to the public it became apparent that it would be very difficult, if not impossible, to distribute more than a total of 250,000 shares to the public. As a result of conferences between the underwriters and the promoters, the Company's initial program, which had [44] called for the expenditure of approximately \$2,000,000, was reduced in scope, it being determined that \$1,250,000 would enable the Company to start operations on a smaller scale. Accordingly, the underwriting agreement was amended as of August 15, 1939, to reduce from 200,000 to 50,000 the number of shares to be sold the public on an agency basis. The total number of Class A common shares to be sold to the public was thus reduced from 400,000 to 250,000.

A total of 250,000 of the Company's Class A common shares (together with warrants for the purchase of 103,333 Class A common shares) were issued by the Company and were accepted and paid for in cash by the underwriters during the period beginning July 21, 1939, and ending November 28, 1939.

On or about February 15, 1940, the Company completed its factory at Hawthorne, California. On

March 1, 1940, the Company had 142 employees, which number rose to 192 by the end of the month. On March 4, 1940, the Company had unfilled orders in the amount of \$760,249.16, consisting solely of one contract dated December, 1939, with Consolidated Aircraft Corporation for the manufacture of seats, cowls and empennages for the United States Army and Navy airplanes. On March 12, 1940, the Company got an order from the Norwegian Government for 24 Navy planes, the total contract price being \$1,558,582.62. Prior to October 22, 1940, the Company had entered into contracts totalling \$24,000,000.

On March 4, 1940, the Company faced substantial competition, including that offered by Douglas Aircraft Co., Inc., North American Aviation Company, Lockheed Aircraft Corporation, Consolidated Aircraft Corporation, Boeing Aircraft Company and Vultee Aircraft Corporation, all of which were [45] established aircraft manufacturing companies having operating plant facilities on the west coast and having proven products ready for sale.

As of February 29, 1940, the book value of the Company's then outstanding 282,305 Class A shares and 67,689 Class B shares was \$1,309,436.38. As of July 31, 1940, the book value of the Company's then outstanding 282,305 Class A shares and 67,689 Class B shares was \$1,199,174.93. As of July 31, 1941, the book value of the Company's then outstanding 282,305 Class A shares and the 74,637

Class B shares was \$156,331.54.² The Company had no earnings prior to March 4, 1940, nor had it paid any dividends on its stock. The Company suffered a loss in the fiscal year ending July 31, 1940, which was capitalized. In the fiscal year ending July 31, 1941, the Company suffered a net loss in the amount of \$848,778.33. The Company first showed earnings in the fiscal year ending July 31, 1942, and it first declared and paid dividends on its stock in November, 1943.

The Class A common shares of the Company that were sold to the public and upon which there were no restrictions or limitations as to sale, dividends or rights to participate in distribution of assets (hereinafter called "unrestricted Class A common shares"), were never, during 1939 or 1940, traded or listed on any securities exchange, but were traded on an over-the-counter basis through securities dealers.

The unrestricted Class A common shares were traded in for the most part in relatively small blocks of 100 or less, at prices ranging from a [46] low of 5 to a high of $6\frac{7}{8}$ during the period beginning November 9, 1939, and ending March 8, 1940. On March 1, 1940, 100 such shares were traded

²The sharp decrease in book value as of July 31, 1941, as compared with the prior year, is principally due to a very substantial increase in the latter year of current liabilities. This increase in current liabilities consisted principally of advances received on contracts in excess of expenditures thereon.

at $57/8$, 50 at $61/8$, and 100 at $61/4$. On March 5, 1940, 100 were traded at $57/8$, and 100 at $63/8$.

During November, 1940, the unrestricted Class A common shares were traded on an over-the-counter basis at prices ranging from $61/8$ to $71/4$.

During 1940 the highest price at which any such unrestricted Class A common shares were purchased or sold by Lester & Co. was \$8 in April, 1940, and the lowest price at which any such shares were purchased or sold by Lester & Co. was \$5 in May, 1940.

During the period commencing November 9, 1939, and continuing through the year 1940, there was trading by securities dealers in warrants for the purchase of unrestricted Class A common shares. Each of the warrants entitled the holder thereof to purchase one Class A common share at any time on or before December 1, 1944, at the higher of the following prices; (a) \$7 per share, or (b) an amount equal to 80 per cent of the book value of one share of such stock at the end of the quarterly period next preceding the date of exercise.

During the period from November 9, 1939, to and including March 10, 1940, Lester & Co. purchased 196 such warrants and sold 150 such warrants at prices ranging from $\$2-1/8$ to $\$3-1/4$ per warrant, the average price per warrant being \$2.175.

During the period from March 11, 1940, to and including December 31, 1940, Lester & Co. purchased 3,290 such warrants and sold 3,283 such warrants at prices ranging from \$2 to \$4 per warrant, the average price per warrant being \$3.43.

The Class A and Class B promotional shares were worth \$4 a share as of March 4, 1940.

Prior to 1939, petitioners LaMotte T. and Didi Cohn had never lived outside the State of New York. In January, 1939, LaMotte went to Los Angeles in the hope of making an investment for his New York company, Air Investors, Inc. He came in contact with petitioner Northrop and became involved in the organization and financing of the Company, the details of which appear above. LaMotte went to New York early in 1939 in connection with financing the California Company and returned to California. He assisted in the organization of the Company, which was incorporated March 7, 1939. At that time LaMotte intended to take a position with the new company and make California his home if the financial arrangements for the Company were adequately made. By early June, 1939, adequate financial arrangements had been made and the final underwriting agreement was executed June 17, 1939. Early in June LaMotte definitely and finally decided to remain in California and make it his home. He then telephoned Didi, informed her of this decision and told her to close the New York house and come to California. Didi arrived in Los Angeles on or about July 1, 1939. The New York house was later sold. LaMotte on or about June 20, 1939, resigned from Air Investors, Inc., resigned from his various Eastern clubs and otherwise severed his business and social connections in New York. LaMotte and Didi bought a house in California and the children entered school there in September, 1939.

OPINION

Hill, Judge: The first question is whether by virtue of the promotional shares petitioners realized income in 1939 rather than 1940. Since the instant proceeding only involves 1940 a determination that the [48] income, if any, was realized in 1939 would dispose of the cases.

Petitioners earnestly contend that they acquired a proprietary interest in the Company in 1939 which rendered them taxable, if at all, in 1939 rather than 1940. Petitioners argue that the public sales which determined the amount of their interests were made in 1939 and that by the terms of their contracts with the Company their rights to shares accrued as of the date of such public sales notwithstanding the date of actual issuance to them. Petitioners further argue, in effect, that at the end of 1939 merely the formality of the Corporation Commissioner's approval of the escrow agent and the execution of the waivers by petitioners required accomplishment before the issuance of shares to them.

We have carefully considered this argument and have concluded that petitioner's did not acquire a proprietary interest in the Company in 1939. The permit authorizing the Company's stock issue provided that no promotional shares "shall be sold or issued unless and until the applicant [the Company] shall have selected an escrow holder and said escrow holder shall have been first approved in writing by the Commissioner of Corporations * * *." The

permit further provided that no promotional shares "shall be sold or issued unless and until * * *" the petitioners "shall have executed an agreement in writing with said applicant and filed a copy thereof with the Commissioner of Corporations" waiving their rights to dividends and distribution of assets. In 1939 the Commissioner of Corporations had not approved in writing the appointment of the escrow agent nor had petitioners executed their waivers. These requirements were clearly conditions precedent to the Company's authority to issue shares. The Company's authority to issue [49] shares or create proprietary interests derives from the state and is not an inherent corporate power which can be exercised by contract independently of sovereign control. Therefore the Company could only bestow proprietary interests on petitioners when and as authorized by the Commissioner of Corporations. *Live Oak Cemetery Ass'n. v. Adamson, et al.*, 288 Pac. 29. See also *Fletcher Cyclopedia Corporations*, sec. 5158. A recognition of the distinction between the issuance of certificates and the issuance of shares does not affect our conclusion. Nor does the fact that original subscribers to stock are sometimes regarded as stockholders even absent an issuance of shares have application here. We are satisfied that petitioners did not acquire any stock or other proprietary interest in the Company in 1939.

Petitioners alternatively argue that they constructively received a stock or proprietary interest in 1939. From what we have already said it is ap-

parent that the theory of constructive receipt can have no application in the instant situation.

Although not explicitly argued it seems to us that petitioners' position perhaps unconsciously involves a reliance upon the equivalent of cash theory. We have therefore considered the possible application of this theory to the instant situation and have rejected it. It is undoubtedly true that petitioners had a contract right of value. They had fully rendered their considerations, i.e., past promotional services, entering employment contracts, and so on. The Company was obliged to issue certain shares to petitioners subject, of course, to the limitations and requirements imposed by the Commissioner of Corporations. The Company was at least impliedly required under its contracts with petitioners to comply [50] with these limitations and requirements. That these obligations or duties of the Company or the correlative contract rights of the petitioners had value is witnessed by the Ellsworth-Smith transfer described in the facts. Nevertheless, we do not think that petitioners accepted these contract rights as payment. The written contracts were merely evidence of the Company's undertaking and while undoubtedly valuable and transferable with the Corporation Commissioner's permission, they were not given or accepted as payment. Unless the Company's obligation as evidenced by the written contracts with petitioners was accepted by them as payment, we do not think such evidenced obligations can be considered the equivalent of cash even though valuable in the

hands of a cash-basis taxpayer. San Jacinto Life Insurance Co., 34 B. T. A. 186; Frank Kuhn, 34 B. T. A. 274; Great Southern Life Insurance Co., 33 B. T. A. 512, affirmed 89 Fed. (2d) 54, certiorari denied 302 U. S. 698; Schlemmer v. United States, 94 Fed. (2d) 77. It is pertinent in this connection to note that section 22 (a), Internal Revenue Code, defines as gross income, *inter alia*, "compensation for personal services * * * of whatever kind and in whatever form *paid* * * *." (Italics supplied). While contract rights under certain circumstances can be considered the equivalent of cash we do not think the instant situation is properly susceptible to such treatment. Nor as indicated above do we think such contract right should be confused with a proprietary interest in the Company. We therefore conclude that petitioners did not realize income in 1939 by virtue of their situation with respect to the promotional shares in question. [51]

Having determined that any income realized on account of the promotional shares was not realized in 1939 it becomes necessary to determine the value of the promotional shares as of March 4, 1940. The petitioners concede on brief that if 1939 is not the income year that, in that event, March 4, 1940, becomes the crucial date, being the date when the promotional shares were issued to petitioners and the certificates therefor placed in escrow.

Respondent has determined that each share of promotional stock, Classes A and B alike, was worth \$6.25. This value was apparently based largely on

the price for which the unrestricted Class A shares sold for in 1940. Petitioners, on the other hand, contend that the promotional stock had no value as of March 4, 1940. We have found as a fact that each share of promotional stock, Classes A and B alike, was worth \$4 as of March 4, 1940.

We have treated Class A and Class B promotional shares as equivalents in making our evaluation. We have done this for convenience and simplicity, because the parties approach the problem in this manner and because as a practical matter the limitations imposed on the promotional stock virtually eliminated any distinction between the two classes of stock. The Company's option to repurchase the promotional Class B stock for 25 cents a share seems to us to have little significance for evaluation purposes because the petitioners were the directors of the Company and, further, had they exercised such an option for the Company the result would have been to increase the value of the Class A shares. Nor does the junior position of the Class B shares have significance with respect to the promotional shares [52] since petitioners had to waive all their rights to any dividends and distributions of assets. Nor does the provision calling for the cancellation of Class B shares at the end of the 5-year period, if they failed to become convertible, have significance with respect to the promotional shares because if they failed to become convertible, that would mean that there had been no adjusted net profits and therefore the promotional Class A shares would have remained in escrow subject to the waivers. In other words, it seems to us that with respect to the promotional shares the dis-

inction between Class A and Class B was essentially eliminated by the restrictions imposed and, in practical operation, if the Class A shares had any value the Class B shares directly or indirectly acquired an equivalent value. For these reasons we feel warranted in treating them for evaluation purposes as equivalents.

We do not think respondent's evaluation can be sustained. The unrestricted Class A stock sold during 1940 at a high of \$8 and a low of \$5 or at a mean average of \$6.50. Respondent's determination of \$6.25 for the promotional shares, we think too closely approximates the value of the unrestricted shares and fails to give sufficient recognition to the restrictions imposed on the promotional shares in question. We think that the Ellsworth-Smith transfer furnishes the best available indication of the approximate value of the promotional shares and this transfer indicates an approximate value of \$4.50 a share. It is true as petitioners suggest that this transfer was a somewhat isolated transaction but we nonetheless think it offers a reliable approximation of value. We have found a value slightly [53] less than the value indicated by the Ellisworth-Smith transaction. In so doing we have given consideration and effect to such factors as the managerial relationship of petitioners to the Company, the large stock represented by the shares in question and the unproven position of the Company as compared with its more seasoned competitors. After a very careful consideration of these factors, in addition to all the other pertinent evidence bearing on value, we have concluded that \$4

a share represents the fair value of the promotional stock as of March 4, 1940, the crucial date.

The remaining question is whether the promotional shares received by petitioner LaMotte T. Cohu constituted his separate property or was community property. The answer depends on whether LaMotte was domiciled in California when he acquired the shares. We have found as a fact that LaMotte decided to make California his home early in June, 1939, and this fact coupled with his presence in California and the other attendant circumstances of the situation satisfy us that he became domiciled in California at that time. We think that for purposes of determining the community or separate character of the shares that June 17, 1939, is the earliest possible determinative date, being the date LaMotta entered the written contract with the Company by which the Company undertook to issue the promotional shares to him. Since LaMotte was domiciled in California prior to this date, it follows that the shares became the community property of LaMotte and Didi and we so hold.

Decisions will be entered under Rule 50. [54]

Before The Tax Court of the United States

No. 5039—LaMOTTE T. COHU,
No. 5040—DIDI M. COHU,
No. 5041—JOHN K. NORTHROP,
No. 5042—INEZ H. NORTHROP,
No. 5043—GAGE H. IRVING,
No. 5044—ELEANOR SALISBURY IRVING,
No. 5045—EDWARD A. BELLANDE and
MOLLY LAMONT BELLANDE,
No. 5046—MOYE W. STEPHENS and
INEZ B. STEPHENS,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MOTION FOR REVIEW BY FULL COURT

Now Come petitioners, by their attorneys of record, and move that the findings of fact and opinion of the Division of this Court promulgated April 9, 1947, in the above-entitled proceedings be reviewed by the full Court, and show as grounds for their motion the following:

A. The Division's holding that the income, if any, resulting from receipt of promotional shares, was realized [56] in 1940 rather than in 1939 is erroneous in law and is not based on the evidence.

1. In holding that the petitioners neither actually nor constructively receive income in 1939, the Division perhaps inadvertently has opened the door to postponement of realization of income at the elec-

tion of the taxpayer. The only conditions of the Corporation Commissioner's permit which remained to be performed after November 28, 1939, were of a formal and insubstantial nature. Practically speaking, the petitioners received nothing in 1940 that they did not already possess in 1939, and to hold otherwise is to permit a cash basis taxpayer to elect the year of receipt of income.

2. Petitioners' contention that they acquire in 1939 property interests which constituted income to the extent of their fair market value, if any, in that year, is fully supported by the evidence before this Court and the applicable law referred to in petitioners' briefs on file herein.

3. Whether their interests constituted proprietary interests in the Company, economic ownership of shares, equitable title to shares, or contract rights to receive shares, they constituted the "equivalent of cash" if it be assumed that such interests had fair market value in 1939. 2 Mertens, *Law of Federal Income Taxation*, [57] §11.02-11.03. If the exchange by Ellsworth of his interest in the Company is entitled to any weight as evidence of fair market value of the promotional shares on March 4, 1940, (which petitioners do not concede), such exchange would be even stronger evidence of fair market value of the similar interests of the petitioners at the time of the exchange.

B. The Division erred in holding that the restricted Class A and Class B shares issued to the petitioners had a fair market value of \$4 per share or any fair market value as of March 4, 1940. Such

decision is erroneous in law and is not based on the evidence in the following respects:

1. The Class A and Class B promotional shares were erroneously held by the Division to be equivalent in value.

(a) The Division valued all the Class B shares at \$4 each and gave no effect whatever to the Company's option to purchase, at 25 cents per share, 60% of the Class B shares issued to petitioners Northrop, Cohn and Irving, which option was exercisable in the Company's sole discretion upon the death of the holder or upon termination of his employment, and was binding upon his successors and assigns. The fixed option price of 25 cents per share constitutes the absolute upper limit of the fair market value of the optioned shares. The Court's attention is respectfully [58] invited to *Helvering v. Salvage* (1936), 297 U.S. 106, 109; *Helen S. Delone* (1946), 6 T.C. 1188, and cases therein cited. There is no merit in either of the two reasons relied on by the Division as its sole basis for disregarding the options.

(1) The fact that petitioners were directors of the Company does not destroy the significance of the options. The Division apparently failed to realize that the petitioners holding optioned stock were only three of a board of nine directors, and together held only about 25% of the total outstanding Class A and Class B shares. Upon the occurrence of one of the conditions entitling the Company to exercise its option, it is obvious that no one of the petitioners holding optioned stock, nor even all three acting together, would be able to prevent the exercise of the option. Moreover, the death of any of those three

petitioners not only would make the option exercisable as to his stock, but also would effectively remove him from the board.

(2) Nor are the options deprived of significance by the fact, relied on by the Division, that their exercise by the Company would result in an increase in the value of the Class A shares. The Division overlooked the fact that the holders of optioned Class B stock held less [59] than 10% of the Class A shares and would enjoy only that proportion of any such increase in value, and that an even smaller percentage would inure to the benefit of a single petitioner as to whose stock alone the option might be exercised.

(b) The statement in the opinion of the Division that the Class B shares, directly or indirectly, would acquire a value equivalent to that of the Class A shares, if any, is based upon a misconception of the facts. Assuming that the Class A shares had any value, the Class B shares could acquire an equivalent value only by becoming convertible to Class A stock, share for share. That could happen only (1) at the end of the 5-year period if adjusted net profits had then amounted to 50 cents per annum per Class A share, or (2) during the 5-year period if and when adjusted net profits amounted to \$1,000,000. If Class B shares failed to become convertible to Class A shares on a share for share basis, the Class B shares might have become void if no adjusted net profits were earned by the end of the 5-year period, or they could have become convertible to a proportionately smaller number of Class A shares if the adjusted net profits amounted to less than 50 cents per annum per

Class A share. To hold that the Class A and B shares were equivalent in value as of March 4, 1940, is to hold that it was substantially certain as of that date that the Company would, by the end of the 5-year period (August 1, [60] 1944), realize adjusted net profits equal either to 50 cents per annum per Class A share or to a total of \$1,000,000; and such a holding is entirely without support in the evidence.

(c) The duration of the restrictions upon the Class B shares under the Articles of Incorporation depended upon different considerations than did the duration of the restrictions imposed upon the Class A shares under the Corporation Commissioner's permit. Under the Articles the Class B shares could in no event participate in dividends prior to July 1, 1942, and could participate thereafter on an equal basis with Class A shares only if adjusted net profits had then amounted to 50 cents per annum per Class A public share. Furthermore, under the Articles the Class B shares were junior to all Class A shares as to distribution of assets for a period of 5 years, a junior position which could have been terminated in less than 5 years only if the Company made adjusted net profits of \$1,000,000, thereby making the Class B shares convertible to Class A shares. The Corporation Commissioner's restrictions, being subject to less rigid conditions as to duration, could have been lifted, at least as to Class A shares, before the strict requirements of the Articles as to Class B shares had been met, and in fact approximately $\frac{1}{3}$ of the Class A promotional shares were released from the Corporation Commissioner's restrictions in November, 1940.

If the Class A shares had any value at all on March [61] 4, 1940, (which petitioners do not in the least concede), the Class B shares had a far smaller value, if any, and the value of the optioned Class B shares could in no event exceed 25 cents per share.

2. Wholly aside from the failure to differentiate between Class A and Class B shares as to value, the Division erred in determining that either the Class A or the Class B shares were worth \$4 per share, or any amount, on March 4, 1940.

(a) The finding of value is based almost wholly upon one isolated exchange by Ellsworth (who was not connected with the Company's management). That exchange (1) occurred more than 3 months prior to the valuation date, (2) was the result of personal solicitation and negotiation over a period of 90 days with a party particularly interested in Southern California aviation stocks, (3) involved less than 5% of the number of shares held by petitioners, and (4) involved payment of a 12% commission to the intermediary negotiating the transaction. These peculiar and unusual circumstances deprive that transaction of any substantial weight as evidence of fair market value.

(b) Despite the fact that respondent presented no evidence (aside from stipulated facts), the Division disregarded the uncontradicted testimony of petitioners' two expert witnesses that, in view of the restrictions and the speculative nature of the stock, neither the [62] Class A nor Class B promotional shares had any fair market value on March 4, 1940.

(c) The Division apparently disregarded the evidence as to the speculative nature of the stock, as

well as the numerous decided cases holding that restricted stock in a new and unproven corporation has no fair market value. The Court's attention is respectfully invited to *Helvering v. Tex-Penn Oil Co.*, (1937), 300 U.S. 481; *U.S. v. State Street Trust Co.*, (C.C.A. 1st, 1942), 124 F. (2d) 948, *aff'g*. 37 F. Supp. 846; *Schuh Trading Company v. Commissioner*, (C.C.A. 7th, 1938), 95 F. (2d) 404; and other cases cited in petitioners' opening brief, pp. 94-126.

Wherefore, it is prayed that this motion be granted.

Respectfully submitted,

MAYNARD J. TOLL,
SIDNEY H. WALL,
GEORGE F. ELMENDORF,

By /s/ SIDNEY H. WALL,
Counsel for Petitioners LaMotte T. Cohu, Didi M. Cohu, John K. Northrop, Inez H. Northrop, Gage H. Irving, Eleanor Salisbury Irving, Edward A. Bellande and Molly Lamont Bellande.

RAYMOND W. STEPHENS,
WESLEY G. LA FEVER,

By /s/ WESLEY G. LA FEVER,
Counsel for Petitioners Moye W. Stephens and Inez B. Stephens. [63]

Receipt of a copy of the foregoing motion is acknowledged this 1st day of May, 1947.

/s/ J. P. WENCHEL,
Chief Counsel Bureau of Internal Revenue, Counsel for Respondent.

[Endorsed]: T.C.U.S. Filed May 5, 1947. [64]

The Tax Court of the United States
Washington

Docket No. 5041

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its findings of fact and opinion promulgated April 9, 1947, the respondent herein filed a proposed recomputation of tax on June 11, 1947, and the petitioner filed an acquiescence therein on June 16, 1947. It appearing that such recomputation is correct it is, therefore, in accordance therewith,

Ordered and Decided: That there is a deficiency in income tax for the year 1940 in the amount of \$57,474.19.

(Seal) /s/ SAMUEL B. HILL,
Judge. [65]

Entered June 18, 1947.

The Tax Court of the United States
Washington

Docket No. 5042

INEZ H. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court as set forth in its findings of fact and opinion promulgated April 9, 1947, the respondent herein filed a proposed recomputation of tax on June 11, 1947, and the petitioner filed an acquiescence therein on June 16, 1947. It appearing that such recomputation is correct it is, therefore, in accordance therewith,

Ordered and Decided: That there is a deficiency in income tax for the year 1940 in the amount of \$57,474.19.

(Seal) /s/ SAMUEL B. HILL,
Judge. [66]

Entered June 18, 1947.

In the Tax Court of the United States

No. 5039—LA MOTTE T. COHU,
No. 5040—DIDI M. COHU,
No. 5041—JOHN K. NORTHROP,
No. 5042—INEZ H. NORTHROP,
No. 5043—GAGE H. IRVING,
No. 5044—ELEANOR SALISBURY IRVING,
No. 5045—EDWARD A. BELLANDE and
MOLLY LAMONT BELLANDE,
No. 5046—MOYE W. STEPHENS and
INEZ B. STEPHENS,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

STIPULATION

The parties hereto by their undersigned counsel of record hereby stipulate and agree that the following facts shall be taken as proved in the above-mentioned appeals upon the filing of this stipulation, subject to the right of any party to introduce other and further evidence not inconsistent with the terms of this stipulation, and to the right of any party to object at the time of the trial to the admissibility of any of the facts herein set forth on the grounds of irrelevancy or immateriality.

1. Petitioners John K. Northrop, Inez H. Northrop, Gage H. Irving, Eleanor Salisbury Irving, Edward A. Bellande, Molly Lamont Bellande, Moye W. Stephens, and Inez B. Stephens are now and at all

times material hereto were individuals residing in Los Angeles County, California.

2. Petitioners Inez H. Northrop, Eleanor Salisbury Irving, Molly Lamont Bellande and Inez B. Stephens are now and at all times material hereto were the respective wives of petitioners John K. Northrop, Gage H. Irving, Edward A. Bellande and Moye W. Stephens.

3. Petitioners LaMotte T. Cohu and Didi M. Cohu are now and at all times material hereto were husband and wife and are now residents of Los Angeles, California. [69]

4. The income tax returns of all the petitioners for the calendar year 1940 were filed with the Collector of Internal Revenue for the Sixth District of California. The income tax return of petitioner LaMotte T. Cohu for the calendar year 1939 was filed in a collection district in the State of New York.

5. The income tax returns of all the petitioners for the calendar years 1939 and 1940 were filed on a cash receipts and disbursements basis.

6. Respondent determined deficiencies in the income tax of the petitioners for the calendar year 1940 as follows:

Docket No.	Petitioner	Amount of Deficiency
5039	LaMotte T. Cohu	\$60,490.65
5040	Didi M. Cohu	22,047.92
5041	John K. Northrop	99,479.05
5042	Inez H. Northrop	99,479.04
5043	Gage H. Irving	15,694.14
5044	Eleanor Salisbury Irving	16,381.31
5045	Edward A. Bellande and Molly Lamont Bellande	5,833.34
5046	Moye W. Stephens and Inez B. Stephens	4,455.93

7. Petitioners John K. Northrop, LaMotte T. Cohu, Gage H. Irving, Edward A. Bellande, and Moye W. Stephens, together with T. T. Ellsworth, were the promoters of Northrop Aircraft, Inc., a California corporation (hereinafter referred to as the "Company").

8. The Company was incorporated under the laws of California on March 7, 1939.

9. Petitioner LaMotte T. Cohu has been chairman of the board of directors and general manager of the Company from its inception until the present time. His background and experience in the aviation industry prior to June 21, 1939, are as set forth on page 3 of the prospectus issued under date of June 21, 1939, a copy of which prospectus is attached hereto, marked Exhibit 1-A, and made a part hereof.

10. Petitioner John K. Northrop has been the president and a director of the Company from its inception until the present time. His background and experience in the aviation industry prior to June 21, 1939, are as set forth on page 4 of the prospectus attached hereto as Exhibit 1-A.

11. Petitioner Gage H. Irving has been vice [71] president and a director of the Company from its inception until the present time. His background and experience in the aviation industry prior to June 21, 1939, are as set forth on page 4 of the prospectus attached hereto as Exhibit 1-A.

12. Petitioner Edward A. Bellande was a director of the Company from its inception until on or about October 16, 1941. His background and experience in the aviation industry prior to June 21, 1939,

are as set forth on page 4 of the prospectus attached hereto as Exhibit 1-A.

13. Petitioner Moye W. Stephens became assistant secretary of the Company on February 8, 1940, and a director of the Company on April 16, 1940, and continued in these capacities until on or about January 30, 1946. He commenced flying in 1921 and has been connected with the aviation industry as a transport pilot and in other capacities almost continuously since 1929. In 1937 he represented Lockheed Aircraft Corporation as a special sales representative in Australia and New Zealand.

14. The articles of incorporation of the Company, as amended June 14, 1939, and as in force and effect at all times material hereto, are attached hereto, marked Exhibit 2-B, and made a part hereof. [72]

15. Said articles of incorporation authorize the Company to issue two classes of shares of stock to be designated, respectively, Class A Common and Class B Common.

16. On June 15, 1939, the Commissioner of Corporations of the State of California issued his permit (hereinafter sometimes referred to as the "Corporation Commissioner's Permit") authorizing the Company to sell and issue certain of its securities. A copy of said permit is set forth on page 13 of the prospectus attached hereto as Exhibit 1-A.

17. By separate contracts dated June 17, 1939, between the Company and the respective individual parties thereto, the Company agreed to issue certain Class A Common shares and Class B Common shares of the Company to petitioners John K. Northrop, LaMotte T. Cohu, Gage H. Irving, Edward A. Bel-

lande and Moye W. Stephens, and to T. T. Ellsworth, in the amounts and for the considerations and on the terms and conditions set forth in said contracts, copies of which are attached hereto, marked Exhibits 3-C, 4-D, 5-E, 6-F, 7-G, and 8-H, respectively, and made a part hereof.

18. The Company and certain underwriters made and entered into an underwriting agreement dated June 17, [73] 1939, the provisions of which are summarized on pages 10, 11 and 12 of the prospectus attached hereto as Exhibit 1-A.

19. Amendments to said underwriting agreement dated June 17, 1939, were executed by the parties thereto as of July 12, 1939, and August 15, 1939. Such amendments are summarized on page 15 of the prospectus attached hereto as Exhibit 1-A.

20. The Company issued a prospectus dated June 21, 1939, and added thereto certain supplemental information dated April 26, 1940. A copy of said prospectus, including such supplemental information, is attached hereto, marked Exhibit 1-A, and made a part hereof.

21. During 1939 Atlas Corporation purchased from said underwriters and paid for certain shares and warrants of the Company, in the amounts, for the consideration, and upon the terms and conditions set forth on page 15 of the prospectus attached hereto as Exhibit 1-A.

22. A total of 250,000 of the Company's Class A Common shares (together with warrants for the purchase of 103,333 Class A Common shares) were issued by the Company and were accepted and paid for in cash by said several underwriters upon the dates and

in the amounts set forth in the schedule attached hereto, marked Exhibit 9-I, and made a [74] part hereof.

23. The Company received cash proceeds from the sale of each of the said 250,000 of its Class A Common shares on the dates that said shares were accepted and paid for by said underwriters as set forth in said Exhibit 9-I. The total cash proceeds received by the Company from the sale of said shares and warrants amounted to \$1,250,000.

24. A true copy of Chapters 7 and 9, of a portion of Section 3 of Chapter 2, and of Section 1 of Chapter 10 of the Rules and Regulations of the Division of Corporations, Department of Investment, of the State of California, as in effect during the period from June 1, 1939, to December 31, 1940, is attached hereto, marked Exhibit 10-J, and made a part hereof.

25. None of the Company's Class B shares became convertible to Class A shares prior to August 1, 1942, nor were any of said Class B shares converted to Class A shares prior to August 1, 1942. On August 1, 1942, pursuant to the provisions of Article Five (c)(1) of the articles of incorporation attached hereto as Exhibit 2-B, all Class B shares became convertible, share for share, into Class A shares, by reason of the fact that the Company's adjusted net profits (as defined in Article Five (a)(4) of said articles of incorporation, Exhibit 2-B) computed from August 1, 1941, amounted to more than \$1,000,000. [75]

26. The board of directors of the Company, by resolution adopted June 17, 1939, a copy of which is attached hereto, marked Exhibit 11-K, and made a part hereof, designated Bank of America National

Trust and Savings Association, a bank with trust powers, as escrow holder for the Class A and Class B shares required to be held in escrow by said Corporation Commissioner's Permit, referred to in paragraph 16 above.

27. A copy of a letter dated September 26, 1939, from the Commissioner of Corporations to O'Melveny, Tuller & Myers, counsel for the Company, concerning the conditions set forth in said Corporation Commissioner's Permit, is attached hereto, marked Exhibit 12-L, and made a part hereof.

28. A copy of a letter from O'Melveny, Tuller & Myers, dated September 28, 1939, replying to said letter from the Commissioner of Corporations dated September 26, 1939, is attached hereto, marked Exhibit 13-M, and made a part hereof.

29. The Company, by letter dated January 4, 1940, a copy of which is attached hereto, marked Exhibit 14-N, and made a part hereof, notified said Bank of America National Trust and Savings Association of its designation and requested acceptance by said bank of its appointment as escrow holder. [76]

30. By letter dated January 6, 1940, addressed to said Commissioner of Corporations, a copy of which is attached hereto, marked Exhibit 15-O, and made a part hereof, said bank accepted said appointment as escrow holder.

31. An agreement, dated as of November 30, 1939, and executed by the parties thereto on or about January 4, 1940, was made and entered into between the Company and John K. Northrop, LaMotte T. Cohu, Gage H. Irving, Edward A. Bellande, Moyer W. Stephens, and A. H. Smith (Smith having succeeded

to the rights of T. T. Ellsworth as hereinafter more particularly set forth). A copy of said agreement is attached hereto, marked Exhibit 16-P, and made a part hereof. An executed counterpart of said agreement was filed by the Company with the Commissioner of Corporations on or about January 22, 1940.

32. A copy of a letter dated January 22, 1940, from O'Melveny & Myers, counsel for the Company, to said Commissioner of Corporations transmitting the Company's application for approval of the Bank of America National Trust and Savings Association as escrow holder of the promoter's stock is attached hereto, marked Exhibit 17-Q, and made a part hereof.

33. On January 25, 1940, said Commissioner of Corporations issued his order approving the Bank of America National Trust and Savings Association as escrow holder for the Class A Common shares and Class B Common shares of the Company required to be held in escrow.

34. Pursuant to the provisions of the agreements dated June 17, 1939, (referred to in paragraph 17 above), and pursuant to the provisions of the Corporation Commissioner's Permit dated June 15, 1939, (referred to in paragraph 16 above), the Company on March 4, 1940, issued certificates to Class A Common shares and Class B Common shares of the Company in the following names and in the following respective amounts:

Name	Class A	Class B
John K. Northrop	15,384	38,461
La Motte T. Cohu	7,692	11,538
Gage H. Irving	4,615	10,769
Edward A. Bellande	1,538	2,307
Moye W. Stephens	1,538	2,307
A. H. Smith	1,538	2,307

All said certificates were on the same day placed in escrow with Bank of America National Trust and Savings Association, Los Angeles, California. [78]

35. The receipt of said Bank of America National Trust and Savings Association, for said certificates, as escrow holder, was filed with said Commissioner on or about March 4, 1940.

36. A copy of an application by the Company to the Commissioner of Corporations, dated October 22, 1940, together with all exhibits thereto, is attached hereto, marked Exhibit R, and made a part hereof.

37. By an order dated November 19, 1940, said Commissioner of Corporations ordered 11,000 of the Class A shares then held in escrow to be released from said escrow to the following named persons and in the following respective amounts:

Name	Class A Shares Released
John K. Northrop	5.240
La Motte T. Cohu	2.620
Gage H. Irving	1,580
Edward A. Bellande	520
Moye W. Stephens	520
A. H. Smith	520

38. All of the Class A and Class B Common shares referred to in paragraph 34 above, except for the 11,000 Class A Common shares which were released in November, 1940, pursuant to the afoersaid order of the Commissioner of Corporations dated November 19, 1940, were held in escrow until October 26, 1942, on which date all remaining shares were released from escrow in accordance with an "Order Terminating Escrow" issued by said Commissioner of Corporations on said date.

39. The balance sheet of the Company as of February 29, 1940, a copy of which is attached hereto, marked Exhibit 18-S, and made a part hereof, shows the book value of the Company's then outstanding 282,305 Class A shares and 67,689 Class B shares to be \$1,309,436.38.

40. On March 4, 1940, the Company had unfilled orders of \$760,249.16, consisting solely of one contract dated December, 1939, with Consolidated Aircraft Corporation for the manufacture of seats, cowls, and empennages for United States Army and Navy airplanes.

41. Up to and including March 4, 1940, the Company had made no sales deliveries, and made no such sales deliveries until April, 1940, in which month it made deliveries totaling \$406.98. [80]

42. On March 1, 1940, the Company had 142 employees and during the month of March, 1940, increased the number of its employees from 142 to 192.

43. On or about February 15, 1940, the Company completed the erection of its factory in Hawthorne, California, said factory having approximately 122,500 square feet of floor space.

44. The Company's balance sheet as of July 31, 1940, a copy of which is attached hereto, marked Exhibit T, and made a part hereof, shows the book value of the Company's then outstanding 282,305 Class A Common shares and 67,689 Class B Common shares to be \$1,199,174.93.

45. The Class A Common shares of the Company that were sold to the public and upon which there were no restrictions or limitations as to sale, divi-

dends or rights to participate in distribution of assets (hereinafter called "unrestricted Class A Common Shares"), were never during 1939 or 1940, traded or listed on any securities exchange, but were traded on an "over the counter" basis through securities dealers.

46. The number of unrestricted Class A Common shares purchased and sold by Lester & Co., a Los Angeles [81] securities dealer and one of the underwriters of the shares of the Company, during the period November 9, 1939, to March 8, 1940, and the prices at which such shares were purchased and sold, are set forth in Exhibit 19-U attached hereto and made a part hereof.

47. The number of unrestricted Class A Common shares purchased and sold by said Lester & Co., during November, 1940, and the prices at which such shares were purchased and sold, are set forth in Exhibit V attached hereto and made a part hereof.

48. During 1940 the highest price at which any such unrestricted Class A Common shares were purchased or sold by said Lester & Co., was \$8 in April, 1940, and the lowest price at which any such shares were purchased or sold by said Lester & Co., was \$5 in May, 1940.

49. During the period commencing November 9, 1939, and continuing through the year 1940, there was trading by securities dealers in warrants for the purchase of unrestricted Class A Common shares. Each of said warrants entitled the holder thereof to purchase one Class A Common share at any time on or before December 1, 1944, at the higher of the following prices: (a) \$7.00 per share, or (b) an amount

equal to 80% of the book value of one share [82] of such stock at the end of the quarterly period next preceding the date of exercise.

50. During the period from November 9, 1939, to and including March 10, 1940, said Lester & Co. purchased 196 such warrants and sold 150 such warrants at prices ranging from \$2-1/8 to \$3-1/4 per warrant, the average price per warrant being \$2.175.

51. During the period from March 11, 1940, to and including December 31, 1940, said Lester & Co. purchased 3,290 such warrants and sold 3,283 such warrants at prices ranging from \$2 to \$4 per warrant, the average price per warrant being \$3.43.

52. On November 28, 1939, the following transaction was consummated through White, Wyeth & Co., a Los Angeles securities firm, acting as a principal: T. T. Ellsworth assigned to A. H. Smith, a resident of Houston, Texas, his contract with the Company dated June 17, 1939, (Exhibit 8-H); A. H. Smith delivered to White, Wyeth & Co., 2,500 shares of Duval Texas Sulphur Co., of which 2,200 shares were transferred to T. T. Ellsworth in exchange for his said contract, and 300 shares were retained by White, Wyeth & Co. as its profit in the transaction.

53. On said date of November 28, 1939, T. T. Ellsworth sold 600 of such shares of Duval Texas Sulphur Co. [83] at a price of 7-1/8, for which he received \$4,251.00 on November 29, 1939.

54. Attached hereto, marked Exhibit 20-W, and made a part hereof, is a copy of the ledger accounts of T. T. Ellsworth and A. H. Smith with White, Wyeth & Co. relating to said transaction.

55. The following sales of Duval Texas Sulphur

Commissioner, by order dated July 31, 1940, consented to the transfer of said shares in accordance with said application upon the [86] condition that the new certificates evidencing such shares be deposited with Bank of America National Trust and Savings Association and held in escrow in accordance with the conditions of said Corporation Commissioner's Permit dated June 15, 1939, and upon the further condition that the old certificate or certificates be immediately cancelled.

62. The first meeting of the shareholders of the Company was held on October 16, 1940.

Dated November 12, 1946.

/s/ J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

MAYNARD J. TOLL,
SIDNEY H. WALL and
GEORGE F. ELMENDORF,

By /s/ SIDNEY H. WALL,
Counsel for Petitioners LaMotte T. Cohu, Didi M. Cohu, John K. Northrop, Inez H. Northrop, Gage H. Irving, Eleanor Salisbury Irving, Edward A. Bellande and Molly Lamont Bellande.

RAYMOND W. STEPHENS and
WESLEY G. LA FEVER,

By /s/ WESLEY G. LA FEVER,
Counsel for Petitioners Moye W. Stephens and Inez B. Stephens.

[Endorsed]: T.C.U.S. Filed Nov. 12, 1946. [87]

The Tax Court of the United States

[Title of Causes Nos. 5039-40-41-42-43-44-45-46.]

Court Room No. 229, United States Post Office and
Court House Building,

Los Angeles, California.

November 12, 1946—10:00 A.M.

(Met pursuant to notice.)

Before: Honorable Samuel B. Hill, Judge.

Appearances: Sidney H. Wall and George F. Elmendorff, 433 South Spring Street, Los Angeles 13, California, appearing for Petitioners in Docket Nos. 5039 to 5045, inclusive. Wesley G. LaFever, 1122 California Bank Building, Los Angeles, California, appearing for Petitioners Moye W. Stephens and Inez B. Stephens, Docket No. 5046. R. E. Maiden, Jr., (Honorable J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue), appearing for the Respondent. [92*]

The Clerk: Docket No. 5039 LaMotte T. Cohu, 5040, Didi M. Cohu, 5041, John K. Northrop, 5042, Inez H. Northrop, 5043, Gage H. Irving, 5044, Eleanor Salisbury Irving, 5045, Edward A. Bellande and Molly Lamont Bellande, 5046, Moye W. Stephens and Inez B. Stephens.

The Court: Announce your appearances.

Mr. Wall: Sidney H. Wall for the Petitioners in Docket Nos. 5039 to 5045, inclusive.

* Page numbering appearing at foot of page of original certified Reporter's Transcript.

Mr. Maiden: R. E. Maiden, Jr., for the Respondent.

Mr. Elmendorf: George F. Elmendorf for the Petitioners in Docket Nos. 5039 to 5045, inclusive.

The Court: How about 5046?

Mr. Wall: Mr. Wesley G. LaFever, your Honor, has entered his appearance for the Petitioners in that case, and I have just called his office and he is on his way here.

The Court: For the Respondent?

Mr. Maiden: R. E. Maiden, Jr., for the Respondent, your Honor.

The Court: Are these cases to be consolidated for the hearing?

Mr. Wall: If your Honor please, I should like to so move at this time, that they be consolidated.

The Court: Does that include 5046?

Mr. Wall: Yes, that includes Docket No. 5046, and [93] Mr. LaFever has advised both Mr. Maiden and myself that he joins in that motion.

The Court: Any objection to the motion?

Mr. Maiden: No object, your Honor. I think it is proper.

The Court: They may be consolidated for hearing.

Mr. Wall: Will that also include consolidation for the purpose of brief, your Honor? I suppose it will.

The Court: Yes, it will. State your case for the Petitioners. [94]

Mr. Wall: If your Honor please, the parties have entered into a rather lengthy stipulation of

facts, which I have already mentioned. There are certain portions of this stipulation on which the Petitioners, however, reserve an objection to materiality. We do not question the existence of these facts, and we have gladly stipulated to them but we do wish to reserve an objection as to their admissibility in this proceeding. I should like to present the stipulation at this time, and if your Honor cares to hear the argument on the question of the admissibility, I would be happy to go forward with that.

The Court: You have noted in the stipulation at the proper points, I take it, your objections?

Mr. Wall: No, your Honor, the objections are not specifically noted in the stipulation, I am sorry to say. The entire stipulation was made subject to the right of either [95] parties to object to the relevancy.

The Court: You may indicate your objections at this time. I do not care to have that argued or to pass on them at this time.

Mr. Wall: Well, the Petitioners object to the admissibility in evidence of the following provisions of the stipulation: Paragraph 36 and Exhibit R. Would you want me to mention briefly what the nature of the facts are in each case?

The Court: You may mention briefly, but do not take too much time on it.

Mr. Wall: That is Petitioners application to the Corporation Commissioner for release of the escrow dated October 22, 1940. We object to paragraph 44 and Exhibit T incorporated thereby, which is

a balance sheet of the company as of July 31, 1940. We object to paragraph 47 and to Exhibit V, incorporated therein which constitutes a tabulation of the sales and purchases of the Northrop Class A public shares handled by Lester & Company during the month of November, 1940. We object to paragraph 48 which states the high and low prices in the 1940, of the unrestricted Class A shares, and object to paragraph 51, which is a summary of the sales and purchases of warrants handled by Lester & Company for the period March 11, 1940, to December 31, 1940. We object to paragraph 61, which relates to an [96] application made on July 26, 1940, by LaMotte T. Cohu to the Corporation Commissioner for permission to transfer certain of his Class C shares to his wife and daughters by way of gift.

I might state very briefly, your Honor, that our objection to all of these items is based on the fact that all of them occurred or followed the facts occurring after March 4, 1940. We object to their being considered in determining the fair market value of these shares as of March 4, 1940, unless and until some proper foundation is laid showing that they were either foreseen or reasonably foreseeable at that valuation date. Subject to the objections that I have just mentioned, I will renew the offer of the filing and—I guess the filing is all that is necessary.

The Court: The stipulation will be received.

Mr. Maiden: If the Court please, I was just wondering if the Court would want to take the

time to have me state Respondent's reasons for believing that the facts and circumstances in this case occurring both before and subsequent to our basic date are material evidence in the case, or whether the Court would prefer that I cover the points of objections in my brief.

The Court: I think it would be just as well to cover them in your brief. Of course if you should make your statement now the Petitioner would be entitled to give him [97] reasons for his objections.

Mr. Maiden: It is understood that both sides in their brief will have ample opportunity.

The Court: Either party. That is a good way to argue the question.

Mr. Maiden: That is satisfactory to me, your Honor.

Mr. Wall: That is satisfactory to me, your Honor. I would like clarification on one point, in view of the fact that we will not know during the hearing whether or not those items are to be admitted, I will be in this position, that if those items are admitted there are certain facts I may wish to bring out from witnesses produced on behalf of the Petitioners, which likewise relate to events subsequent to March 4, 1940.

The Court: You may do that without prejudice to your objections.

Mr. Wall: Thank you, your Honor, may I proceed with the evidence?

The Court: You may proceed.

Mr. Wall: I will call Mr. Claude M. Monson.

Whereupon,

CLAUDE M. MONSON,

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows: [98]

The Clerk: State your name and address, please.

The Witness: Claude M. Monson, 425 West Buckthorne, Inglewood, California.

Direct Examination

By Mr. Wall:

Q. Will you please state your business or occupation, Mr. Monson?

A. I am the Financial Vice President of Northrop Aircraft, Inc.

Q. When did you enter the employ of Northrop Aircraft, Inc.?

A. Actual employment of this company, October 9, 1939.

Q. Had arrangements been made prior to that date for your employment by the company?

A. Yes, sir, I was contacted around the first of March, 1939, relative to coming to work for them and had accepted at that time.

Q. But you actually began your active work in October? A. That is right.

Q. Have you been with the company ever since that time? A. Yes, sir.

Q. What was your position with the company when you began in October, 1939?

A. I came in as Auditor of the company.

(Testimony of Claude M. Monson.)

Q. How long did you continue to hold that position? [99]

A. For a very few months. I was made Assistant Treasurer in January of 1940, somewhere in January.

Q. Was there a Treasurer of the company at that time? A. No, sir, there was not.

Q. Were you then chief financial officer of the company beginning in January, 1940?

A. Yes, sir.

Q. And did you hold that position until on or after March 4, 1940? A. Which position?

Q. Assistant Treasurer. A. Yes, sir.

Q. What other positions have you held in the company since that time?

A. Well, from there I was advanced to the position of Treasurer and then I became Vice President and Treasurer and I was made a member of the Board of Directors and the Financial Vice President.

Q. You are now Financial Vice President and a member of the Board of Directors?

A. Yes, sir.

Q. Going back to the period around March 4, 1940, you have testified, Mr. Monson, that you were then Assistant Treasurer of the company and its Chief Financial Officer by reason of the fact that the office of Treasurer was vacant. [100] In that position were you then familiar with the financial condition and affairs of the Northrop Aircraft, Inc.? A. Yes, sir.

(Testimony of Claude M. Monson.)

Q. And were you also familiar with its business and prospects for business as of that time?

A. Yes, sir.

Q. In answering the next question that I am going to put to you, Mr. Monson, I would like to have you put yourself as nearly as you can at March 4, 1940, and answer that with respect to conditions as they existed then. On March 4, 1940, did the Northrop Aircraft Company have a product ready for sale? A. No, sir.

Q. Did it have any airplanes then in the design stage?

A. Yes, they had. The company was organized in 1939. We immediately started a project design on a flying wing airplane. We had done a very small amount of work in sketching three-views for configurations of an airplane and the like on a machine we termed the 8A.

Q. That is Model 8A?

A. That is right.

Q. What type of airplane was that in general?

A. That would be a single-engine military craft which we hoped we could get orders for.

Q. You stated that you had begun to prepare three-views. [101] Will you explain to the Court what you mean by three-views?

A. Well, the three-view of an airplane shows the side view, the top view and the front view of the airplane.

Q. Does the preparation of the three-view involve special engineering work on the airplane?

(Testimony of Claude M. Monson.)

A. Oh, no, this three-view, the total cost of preparing the three-view on this——

The Court: What is that word?

The Witness: Three, t-h-r-e-e view.

The Court: I thought you said free f-r-e-e view.

The Witness: Three, t-h-r-e-e view, and those just run from \$50.00 to \$100.00 each.

Q. (By Mr. Wall): That was a mere preliminary step in designing an airplane?

A. That is right.

Q. Now you said that you had commenced to design a flying wing. How far had the design work progressed on the flying wing up to March 4, 1940?

A. Merely that it was just taking form on a piece of paper and studies were being made as to the design.

Q. Was the engineering by any means completed on that airplane?

A. No, it hadn't even been started, as far as the engineering goes. [102]

Q. Was the same true of this Model 8A which you mentioned? A. Yes.

Q. Had there been any provision for production of either of those airplanes?

A. No, sir.

Q. Did you have any airplanes at that time then in a design stage? A. No, sir.

Q. Did the company then have any orders on its books? That is, March 4, 1940?

A. Had a Consolidated Aircraft order.

(Testimony of Claude M. Monson.)

Q. That was the order of approximately \$760,000 total?

A. That is right, and it covered empennages on P. B. Y. 2 airplanes.

Q. Will you explain what the empennage of an aircraft is, Mr. Monson?

A. The empennage of an airplane is the tail section.

Q. Was that Consolidated Aircraft order on a fixed price basis? A. Yes.

Q. I think it is in evidence that the order was dated December, 1939. Does that check with your recollection, Mr. Monson?

A. That is right, yes.

Q. Will you please state the circumstances under which [103] that Consolidated order was obtained by Northrop?

A. Well, we had an organization started, the nucleus of an organization. We had our plans pretty well along and it was discussed and determined that we should go out and try to get some subcontract work for some of the other aircraft manufacturers, for the purpose of defraying some of the overhead of the organization until such time as Northrop Aircraft could design and get a product for sale. In order to get this business we had figured our estimates as low as we possibly could, on the basis of a break-even point, and had taken the job merely to defray the overhead expenses while we were getting going. That was the estimated basis.

(Testimony of Claude M. Monson.)

Q. You say it was estimated to an estimated break-even point, or it was price at an estimated break-even point. What do you mean by that?

A. I mean just what we thought we could do the job for and not make any profit.

Q. Did you not at the time when the order was obtained anticipate making a profit on that order?

A. No, sir, because we could not risk getting in there with a profit margin on it, because the rest of the industry could take that much business away from us so we had gone in purely on that basis.

Q. And that was the only order you had on your books on March 4, 1940? [104]

A. That is right.

Q. Had you prior to that time sought sub-contract work of other aircraft companies?

A. Oh, yes, naturally we had been to all of the aircraft companies here on the West Coast and told them that we were looking for their sub-contract work.

Q. You had not then received any orders?

A. No, we hadn't received any orders.

Q. Did you have any immediate prospect on March 4, 1940, of receiving orders from other aircraft companies?

A. No, sir.

Q. What was the general competitive situation facing the Northrop Aircraft Company as of March 4, 1940?

A. Well, out in this area we had Douglas Aircraft, North American Aviation, Vultee Aircraft,

(Testimony of Claude M. Monson.)

Consolidated, Boeing, who all old-established aircraft companies, had operating plant facilities, employees, products to sell. We came in as youngsters into this group of organized aviation companies to try to make out. I think that I could illustrate just what the competition was. We had word of a Navy order coming up in the East, and we had made our proposals as to what we could build this Navy airplane for. We had gone to a lot of work and had bid the thing as close as we could and we were assured by those people in power in Washington that this order would be accepted. We found that our competitors put [105] in a written note to the Bureau of Aeronautics to the effect that Northrop neither had a plant nor a personnel in the plant to produce the product, so it was pulled right out from under our hands and given to one of our biggest competitors.

Q. Was that prior to March 4, 1940?

A. It was either prior or right after.

Q. You named several aircraft companies that you considered to be established out on the Coast. Could we also mention Lockheed Aircraft Corporation?

A. Oh, yes, I just skipped them.

Q. What was the outlook as of March 4, 1940, with respect to possible profits of the company?

A. We hadn't anticipated any profits in 1940 at all. We could not on the basis of the business that we had on hand.

Q. Had you then had enough experience in

(Testimony of Claude M. Monson.)

working on the Consolidated sub-contract order to know whether or not you were going to make a profit on that?

A. Well, that developed rather rapidly. The P. B. Y. 2 airplane which Consolidated were manufacturing was an obsolete airplane in the first place, and it was agreed that they would furnish the drawings and the tooling with which we would make the empennages. As this tooling and the drawings came to our plant, in order to properly put them together to work we found that considerable additional work would [106] have to be done to bring the drawings up-to-date, to make changes all the time in order for us to put out a satisfactory product, so immediately after this stuff started coming in to us we knew then that we were going to run a loss on that particular contract.

Q. Was that your view on March 4, 1940?

A. Yes, sir.

Q. Mr. Monson, did the company receive an order from the Norwegian Government for certain Navy airplanes shortly after March 4, 1940?

A. Yes, sir.

Q. Do you recall the date on which that order was received?

A. March 12, I believe.

Q. What was the nature of that order?

A. That order covered 24 N3PB airplanes.

Q. Would you translate that?

A. That is a Navy patrol bomber.

Q. Was that a single-engine airplane?

(Testimony of Claude M. Monson.)

A. Single-engine plane.

Q. Did you say 24 of those bombers?

A. 24.

Q. And you received that order on the 12th of March?

A. Yes, sir.

Q. Was that known to the company on March 4th, 1940, [107] before you received that order?

A. No, it was not.

Q. Will you state the circumstances concerning the obtaining of that order and particularly the facts as they existed on March 4, 1940, and as known to you and to the company?

A. We knew that the Norwegian Purchasing Commission, if that happens to be its legal name, were here on the West Coast for the purpose of buying airplanes for the Norwegian Government. In our business you know who your competitors are and you knew where there people were. We knew that these people were dealing with Douglas Aircraft, that the Army section of this Commission had already placed an order with Douglas Aircraft for their product, and the Navy Department were definitely leaning that way. We went out and made an offer to the Norwegians as to what we would build 24 airplanes for. We did not know as of the 4th day of March whether or not that business would develop or whether it would not. Of that I am definitely certain because on or about the 10th or 11th of March Mr. Cohu decided to go back East for the purpose of seeing if he could do a little more selling and see the

(Testimony of Claude M. Monson.)

Commission and I says as he was leaving, "If we are successful, if there is any possible chance of getting this business, please let me know so that I can arrange for a performance bond" because performance bonds [108] and payment bonds are always necessary in the construction of airplanes, and he says "Well, there will be a lot of time for that, because we don't know." So I know the date.

Q. Did he later advise you that the order had been obtained, requesting you to get a performance bond?

A. Yes, he left by airplane, and weather conditions put him down in Texas somewhere or New Mexico, and he phoned me at eleven o'clock at night and informed me that he had been contacted and that the Norwegians would give us the business provided we could furnish the performance bond by next morning.

Q. When was that phone call made, to the best of your recollection?

A. That was the night of the 11th, the 10th or 11th, I couldn't say sure. So I got out at eleven o'clock at night and got a performance bond by two o'clock in the morning.

Q. Was there any business not then on the books of the company that might reasonably be anticipated as of March 4, 1940? A. No.

Q. There was nothing which you knew at that time which would lead you to believe that you

(Testimony of Claude M. Monson.)

were going to get any particular business or business at all, is that correct?

A. No, there was not. [109]

Q. Now you have mentioned this Consolidated order? A. Yes, sir.

Q. Which on March 4, 1940, was in the amount of \$760,000. Did the company actually make a profit or make a loss on that \$760,000 Consolidated order which was on its books on March 4, 1940?

A. The company took a loss.

Q. You have also mentioned this Norwegian contract. Did the company make a profit on the Norwegian contract or a loss? A. Loss.

Q. I assume that the Norwegian contract was not completed until sometime after 1940, is that correct?

A. That is right. It was not completed until 1941.

Q. When you first received the Norwegian contract did you then anticipate making a profit on it?

A. No. Well, yes, we may have anticipated making a small margin of profit, but 24 airplanes with tooling you can't consider very much.

Q. As of March 4, 1940, Mr. Monson, had the company made any earnings whatsoever?

A. No, sir.

Q. And had it declared or paid any dividends at that time? A. No, sir. [110]

Q. When did the company show earnings?

A. The fiscal year ended July 31, 1942.

(Testimony of Claude M. Monson.)

Q. What had those earnings showing a profit and loss position been on prior years?

A. The year 1940, inasmuch as our sales only amounted to two or three thousand dollars for the entire year, the books were closed and we took a loss on the basis of organization expenses and those things which had been paid out during the year.

Q. You mentioned the year ended 1940. Do you mean the fiscal year ended July 31, 1940?

A. Yes, the fiscal year ended July 1, 1941, and the company had a loss of some \$827,000.

A. When did the company first pay a dividend on its stock?

A. 1943, declared in November, 1943.

Q. Mr. Monson, I would like to show you Exhibit R attached to the stipulation on file which is an application to the Commissioner of Corporations of the State of California made by Northrop Aircraft, Inc., under date of October 22, 1940, in which the company requested the Commissioner to release from escrow approximately one-third of the Class A promotion shares which had been placed in escrow under the Commissioner's permit. I would like to direct your attention particularly to Exhibit B attached to the application which [111] is here designated as Exhibit R. Exhibit B to the application begins this way: "The following is a list of contracts held by the Northrop Aircraft, Inc., making a total backlog of \$24,000,000 odd." This then is a list of contracts

(Testimony of Claude M. Monson.)

said to be held by Northrop Aircraft on October 22, 1940. I direct your attention to Item No. 1 therein, dated March 12, 1940, for the Norwegian Government. Is that the Norwegian contract concerning which you have already testified?

A. Yes, sir.

Q. I direct your attention to Item No. 2, Experimental Contract dated June 29, 1940, by the United States Navy covering design data for a contract price of \$35,302.50. Can you state whether or not that contract which was dated June 29, 1940, for the Navy was foreseen on March 4, 1940?

A. No, sir, it was not. The bid circular on that particular one was not circulated until about April.

Q. You mean then that you did not place that bid until some time after that circular was issued?

A. That is right.

Q. I call your attention to Item No. 3, Experimental Contract for the United States Army, dated April 29, 1940, relating to magnesium wing design, etc., for a total contract price of \$17,640.00. Was that contract foreseen on March 4, 1940?

A. No, sir. [112]

Q. I call your attention to the item of an Experimental Contract dated May 6, 1940, for the United States Army, for the design of a bomber for a total contract price of \$15,920.00. Was that contract foreseen on March 4, 1940?

A. I think in February we had put up a \$100,000 bid deposit.

(Testimony of Claude M. Monson.)

Q. Had you made a bid on that job in February? A. Yes, sir.

Q. Had you done any work prior to March 4, 1940, as to making an airplane for that Army job? A. No, sir.

Q. I call your attention to Item No. 6 Experimental Contract dated September 4, 1940, with the United States Army for the design and construction of a prototype pursuit plane for a total contract price of \$404,600.00. Was that contract anticipated or foreseen on March 4, 1940?

A. No, sir, that contract originally started out for \$11,000.00 for some wind tunnel models and drawings, and later on was supplemented to the prototype of the pursuit airplane, but contracts when they are supplemented always bear the original date.

Q. When did you do the first work on the wind tunnel job which you say started that job?

A. It started about in June, I believe.

Q. Was that contract anticipated or foreseen on [113] March 4, 1940?

A. No, sir, it was not.

Q. I direct your attention to Item No. 7 on this list Experimental Sub-contract dated June 3, 1940, with E. F. Zap relating to flaps and ailerons for the United States Navy, price \$32,500.00. Was that contract foreseen or anticipated on March 4, 1940?

A. I don't know. Mr. Zap was a gentleman who was doing some development work in our plant

(Testimony of Claude M. Monson.)

and we let him have the corner office to do some work around there. Now, then he got his contract from the Navy and when he gave us this sub-contract work, outside of the date that you have mentioned to me I don't know?

Q. He was using rented space in your plant to work on his own on March 4th?

A. He was using one office.

Q. I call your attention to Item No. 8, contract dated December 29 with the Consolidated for empennages on United States Army planes, for a total contract price of \$1,498,000 odd. Is that the Consolidated contract concerning which you have already testified?

A. No, sir. As I said first, the original Consolidated P. B. Y. 2 was an obsolete airplane, and after April or somewhere in there, when the Government decided to drop the airplanes they had on order, that ship was revised and this [114] is an additional order for empennages.

The Court: What was the year?

The Witness: In 1940, around April or May.

The Court: I thought you said 1939?

Mr. Wall: The contract is dated December, '39.

Q. (By Mr. Wall): But is it correct, Mr. Monson, that it was later supplemented in 1940 after March 4th for the additional items?

A. That is right.

Q. But the contract so supplemented still bore its original date?

A. That is right.

(Testimony of Claude M. Monson.)

Q. The original order of \$760,000 was part of this \$1,498,000, or was that added to the original one?

A. I am sure it is in addition to. It may be an addition that. Yes, this includes the \$790,000.

Q. \$760,000?

A. Yes, and the additional is for the sides and cowls.

Mr. Maiden: Is that Item No. 8 you are referring to?

Mr. Wall: Yes.

Q. (By Mr. Wall): I wish now to call your attention to Item No. 9, contract dated September 19, 1940, for the British Government, to manufacture 24 Vultee V72 dive bombers under license agreement with Vultee Aircraft Company for a total contract price of \$17,000,000 odd. That contract was dated September 19, 1940. Was that contract foreseen or anticipated on March 4, 1940?

A. No, sir.

Q. Can you state the circumstances under which that contract was obtained?

A. Well, the V72 airplane is a Vultee product and I know that Vultee had an order for 40 of such airplanes.

Q. From whom?

A. From the British Government, and the British Government approached Vultee in approximately July of 1940 and asked them to increase the order to 60. Vultee then were not in a position at that time to take the 200 and we contacted

(Testimony of Claude M. Monson.)

them and asked for a license right to make them for the British, and that originally was upon the basis of a license agreement with Vultee, but later we got a license agreement and we did enter into the contract with the British Government.

Q. Approximately when did you contact Vultee seeking that business?

A. I would say July or August.

Q. Did you know that the business might even possibly be available prior to July, 1940?

A. No, no. [116]

Q. Now I will direct your attention to the last item, Item No. 10, Contract dated October 8, 1940, with Boeing Aircraft to manufacture cowls for the Flying Fortress Bombers, total contract \$3,500,000. Was that contract anticipated by the company on March 4, 1940?

A. No, sir, it was not.

Mr. Wall: No further questions.

The Court: Let us take a recess.

(Whereupon, a short recess was taken.)

The Court: Proceed.

Cross-Examination

By Mr. Maiden:

Q. Mr. Monson, with whom were you connected and in what connection prior to going with Northrop in March of 1939, or whatever date it was?

A. October of 1939. Douglas Aircraft.

Q. In what capacity?

A. Internal Auditor.

(Testimony of Claude M. Monson.)

Q. Are you a man of some aviation background or some experience in aviation, or were you at that time?

A. Yes, I started in 1934 with the old Northrop Corporation.

Q. What were your duties?

A. In 1934 I started there as a sheet metal man. I had previously been an accountant, but I started in 1934 as [117] a sheet metal man, due to conditions, and worked up through the Payroll Department where I became in charge of all the accounting at the old Northrop Corporation. In 1937, when Douglas took over the old Northrop Corporation, I remained on the—went with the Douglas people as the auditor for the Northrop Division or the El Segundo Division.

Q. What was the old Northrop Company? What business was it engaged in?

A. Building airplanes and airplane parts.

Q. Did Mr. John R. Northrop have any connection with that company?

A. Yes, sir.

Q. Did he have an official position with them?

A. Yes, Mr. Northrop was the president of the old Northrop Corporation.

Q. Was the old Northrop Corporation at all times a subsidiary of Douglas?

A. Yes, sir. Well, correction I guess. It was the Northrop Corporation. Douglas held the controlling stock, so it was not a subsidiary.

Q. Then you had been acquainted in October of

(Testimony of Claude M. Monson.)

1939 with Mr. John R. Northrop for a number of years?

The Court: Is it John K. or John R.?

The Witness: John K.

Mr. Maiden: John K. Northrop for a number of years? [118] Is that correct, Mr. Monson?

A. Yes, sir.

Q. (By Mr. Maiden): Do you know with what regard Mr. Northrop was held in the aircraft industry as a designer and engineer of aircraft?

A. Yes, sir.

Q. What was that?

A. I think that he held Number One position, practically.

Q. Would you say that Mr. John K. Northrop was considered to be an outstanding designer and engineer in the aircraft industry?

A. Personally, yes.

Q. Was that reputation generally held?

A. I think that it is.

Q. Now, were you employed by Douglas at the time you became connected with Northrop, that is, the new corporation we are speaking of?

A. I was employed by Douglas when I was contacted by the new Northrop Aircraft.

Q. Who contacted you?

A. Mr. Gage Irving.

Q. Was he one of the promoters of the corporation? A. Yes, sir.

Q. Was he a man of some experience in the aircraft [119] industry? A. Yes, sir.

(Testimony of Claude M. Monson.)

Q. Were you acquainted at that time with Mr. Cohu? A. No, sir.

Q. You were not?

A. I never met Mr. Cohu until maybe September or October of 1939.

Q. When you were contacted by Mr. Irving, just briefly, what did he say to you? What did he tell you about coming with Northrop?

A. Well, Mr. Irving contacted me and said that they were thinking about starting a new aircraft company with Jack Northrop as president of it, that they would like to have me under the same roof with them, but because of expenses financially they could not pay me any more than I was getting from my present job, but if I was willing to come with them they would like to have me.

Q. Mr. Monson, did you have a great deal of faith in Mr. Northrop's ability to design, develop and manufacture airplanes? A. Yes.

Q. That faith that you had in him, I guess, was one of the weighty reasons that caused you to give up the employment with an old established corporation and accept employment with this new company, is that correct? [120]

A. That, sir, and a new organization had a gambling chance.

Q. In other words, you did consider it to be a gambling chance? A. I did, sir.

Q. Mr. Monson, what was the condition, if you know, of the aircraft industry in say beginning 1938

(Testimony of Claude M. Monson.)

and 1939 and the beginning of 1940? That is, was it on an upgrade or was it going down?

A. I have been in this thing for quite a number of years, and whenever somebody released a contract, all of the aviation industry fought over it. Whoever got it carried the employees, the actual workmen from the other company into the organization that had the then prevailing work. Now that has happened all the time, and you will find that the employees, mechanics, in the aviation industry have worked in every one of these companies out here, the old-timers, because it has always been a peak and valley affair and it was in 1938.

Q. Well, in 1939 wasn't there a steady up-climb in the demand for military aircraft in the industry in the United States?

A. Out here on the West Coast the only one that I knew of that was going up at that time was Lockheed, because they had some British contracts. [121]

Q. You are aware, Mr. Monson, of the fact that through 1938 and through 1939, war clouders had loomed pretty large on the international horizon, isn't that correct?

A. Yes, sir.

Q. You were aware, were you not, at the time you went with Northrop, that as a weapon of warfare, the airplane was and had for some time been considered by military powers as being one of the most decisive of military weapons, is that correct?

A. I was aware of the fact that that is what we thought of it and the Army Air Forces thought of it. I know there was some controversy with the Navy Department.

(Testimony of Claude M. Monson.)

Q. Do you know whether or not during 1939 prior to the outbreak of the European War on September 1, 1939, the European democracies were feverishly re-arming and were trying to build up their military air forces as fast as possible?

A. I think that is true, yes, sir.

Q. Did that condition obtain likewise in the United States in the latter part of 1939 and the first part of 1940?

A. It started in 1940, I believe.

Q. I believe the facts in this case show that this company was organized for the purpose of designing, developing and manufacturing aircraft and aircraft parts.

A. That is right, sir. [122]

Q. And I believe it was the expression intention of this particular company to specialize in the designing, the developing and manufacturing of military aircraft. Is that your understanding?

A. That is right, sir, that is right. The background on that is that Northrop has always been a military designer.

Q. Has always been a military designer?

A. Yes, sir.

Q. Didn't you feel, Mr. Monson, in 1939 when you were asked to come to Northrop, that Mr. Northrop by reason of his experience and by reason of his recognized leadership in the designing and engineering of military aircraft, that that would be a tremendous asset, his services in connection with the company would be a tremendous asset to that company?

A. Yes, sir, but in making my decision I took it

(Testimony of Claude M. Monson.)

this way, that I had been with this organization where I had been, and I had been told previously to March that I was as far as I would get in that corporation, because of the size of it, that from then on that my salary, if we want to put it that way, would be increased only because of my historical value to the company; all of the positions above me were filled. So, in making my decision to go with Jack, it was just Jack's ability, Mr. Northrop's ability and the chance, the gambling chance that I was taking starting with a new organization in the hopes that I may go farther. [123]

Q. Weren't you of the opinion that national and international relations had so developed that this new company would be successful and would expand and grow rapidly? Wasn't that your expectation when you went with the company in 1939?

A. No, the expectation of the company when I went with them in 1939 was never to have over about 220,000 sq. ft. of floor space and never to employ more than about 2,000 people, with the anticipation that if we could get out of the country some \$15,000,-000 worth of gross sales per year we would be satisfied. We never went with the——

Q. In other words, your corporation would be considered successful on that modest basis?

A. It would be a paying passenger, yes, sir.

Q. Mr. Monson, are you familiar with the prospectus put out by this corporation under date of June 21, 1939, with respect to some of the company's stock? That is Exhibit 1-A to the stipulation in the case.

(Testimony of Claude M. Monson.)

A. I would say that I am. I have seen them all. Yes.

Q. Now, Mr. Monson, I call your attention to a statement in this prospectus which reads as follows: "It is the intention of the company that upon the completion of its initial financing a further detailed survey will be made of the military requirements of the United States Government and foreign governments before definitely determining what type [124] or types of airplanes are to be developed."

Mr. Wall: May I ask what page you are reading from?

Mr. Maiden: That is on page 4 of the prospectus.

Mr. Wall: Thank you.

By Mr. Maiden:

Q. You did understand that the promoters of this company had made some investigation into the needs of the United States Government and other governments, with respect to the types and character of military aircraft that they would want?

A. Yes, sir.

Q. Now, I call your attention to this statement in the prospectus: "The progress of a particular company is determined in an unusual degree by the skill and judgment of its management and its engineering staff." Do you underwrite that statement, Mr. Monson? A. I do, sir.

Q. Did you consider in October of 1939 when you became connected with Northrop that that company did have the skill and judgment necessary to the successful operation of a military aircraft plant?

A. Yes, sir.

(Testimony of Claude M. Monson.)

Q. You considered it A-1, didn't you, Mr. Monson? A. Yes, sir. [125]

Q. Now I likewise call your attention to this statement in reference to the activities of Mr. Northrop: "He has also travelled considerable distances and spent substantial time in conferring with members of the aircraft industry and persons in the military service of the United States and foreign governments, concerning the types aircraft in which they were interested." Did you understand that such a survey had been made by Mr. Northrop and the other members of his company at the time you came with them?

A. I think now you are speaking of the past experience of Jack Northrop.

Q. Well, this has to do, Mr. Monson, with the promotional services rendered by Mr. Northrop to this company in consideration for which he was to receive certain of the promotional shares.

A. Yes, that is right, yes.

Q. Now, Mr. Monson, would you say that after you came to Northrop in October of 1939, and more particularly as of March 4, 1940, that there was a steady and ever-increasing demand for military aircraft in the United States?

A. Oh, yes. I wouldn't say—yes, I guess that would be correct. 1940 is when it started uphill.

Q. I will ask you if the demand for military aircraft which was in existence prior to September 1, 1939, was not greatly accelerated by the outbreak of the European war on [126] September 1, 1939?

A. Yes, that is right.

(Testimony of Claude M. Monson.)

Q. Now, Mr. Monson, considering the fact that this company was built around a nucleus of men of wide and varied experience in the aircraft industry, headed by Mr. Northrop who was considered to be a leader in engineering and designing of military aircraft, considering the fact of the outbreak of the European war on September 1, 1939, and its far-reaching and profound influence upon the demand for military aircraft, not only as respects the defense program of the United States, but more particularly the European democracies who at that time were fighting the battle of their lives, considering the fact that the existing aircraft industry in the United States was not at that time geared to satisfy a degree of this increased demand brought on by the war, didn't you and your associates in Northrop as of March 4, 1940, have high hopes and great confidence and expectations with respect to getting a share of that business that would cause you to grow and expand rapidly and to develop into a successful company?

A. Well, the company was started in—the determination to start the company was made the early part of 1939. We tried to sell that same story to the Navy Department by giving them a long teletype, about four pages, as to our added years experience in the aircraft industry, to combat [127] our competitors saying that we did not have the experience to do the job, and still we lost the business. That is how hungry they were for it even in 1940.

Q. Didn't you feel confident that this company, built upon a man of Northrop's reputation, that

(Testimony of Claude M. Monson.)

after it had completed its financing—I believe the facts are that its plant had been completed on January 15, 1940? A. That is right.

Q. Didn't you feel that Northrop's name and Northrop's reputation would create a certain amount of business for that company as soon as it could get in an operating position?

A. I did, yes, otherwise I never would have gone with them.

Q. I guess you will agree with me on this point, that as of March 4, 1940, the American aircraft industry was on the threshold of its most prosperous and expanding period in its entirely history, is that correct?

A. From hindsight I'm saying yes, from foresight I don't think we knew it.

Q. Mr. Monson, of course you do not want to represent to the Court here that a man of your experience in the aircraft industry, that on March 4, 1940, you did not anticipate and Mr. Northrop did not anticipate and this company did not expect to receive all the business that they could take care of just as soon as they got their plant completed and equipped [128] with personnel? You don't want to represent that to the Court, do you, Mr. Monson?

A. No, I would say that when we first organized the company we intended to get our share of what was in the field of operation.

Q. And you had high hopes and expectations of doing that at the time this corporation was organized, is that correct, Mr. Monson?

A. Well, if you will look at this book here you

(Testimony of Claude M. Monson.)

will find that we expected losses for the first two years.

Q. That would be anticipated with any new business wouldn't it, and particularly in the aircraft business, you would naturally expect in your initial development stage you would naturally expect to show losses, is that right?

A. We understood that we would have a two-year period in which we would have to develop a plane to be marketed and we would have to get a contract to produce that airplane before any profit could be anticipated.

Q. That was all in the initial development stage?

A. Yes, sir.

Q. As soon as you passed that stage you had no doubt of the ability of this company to hold its own with the others, Mr. Monson?

A. No, sir.

Q. Now, Mr. Monson, I want to ask you if you will identify [129] this booklet here for me.

A. It is the Northrop Aircraft Incorporated's 1940 Annual Report to the Stockholders.

Q. Does this booklet contain a statement as a sort of a preface to the balance sheet as of July 31, 1940?

A. Yes, sir.

Q. And it is dated October 10, 1940, is that right?

A. That is right.

Q. Does this show a comparison of unfilled orders and deliveries from August 1, 1939, to October 1, 1940?

A. Yes, sir.

Q. Does it show that as of October 1, 1940, the unfilled orders of this company had increased from zero on January 1, 1940, to \$20,617,586.14?

(Testimony of Claude M. Monson.)

Mr. Wall: If your Honor please, I object to that on the same ground upon which I noted an objection to portions of the stipulation, on the ground that it occurred subsequent to the valuation date.

The Court: That is of the same type to which you objected before?

Mr. Wall: That is right.

The Court: I will overrule the objection and let him answer.

The Witness: Yes, sir, it does.

By Mr. Maiden: [130]

Q. And this shows an analysis of unfilled orders, is that right? As of October 6, 1940?

A. Yes, sir.

Q. In other words, it breaks down this total figure of \$20,000,000 showing the customers from which the business was obtained, is that correct?

A. That is right.

Q. And this shows total United States Army orders of \$803,312.00, is that right? A. Yes, sir.

Q. And total United States orders of \$728,797.10, is that correct? A. Navy.

Q. That is Navy, United States Navy orders.

A. That is right.

Q. And military export of \$18,601,222.62. Will you explain what you mean by military export?

A. That is British, anything outside of the United States, and other foreign powers.

Q. And then you show a military export sub-contract, \$484,272.42.

A. That military sub-contract could be through and was through one of the local aircraft manufac-

(Testimony of Claude M. Monson.)

turing companies here which was doing work for Great Britain.

Mr. Maiden: For Great Britain, if the Court please [131] I would like to have this marked for identification as Respondent's Exhibit No. 1.

The Court: Do you want to offer it?

Mr. Maiden: Yes, sir, I do want to offer it.

Mr. Wall: Same objection, your Honor.

The Court: The objection is overruled. Admitted. It would not be No. 1. This would be Respondent's Exhibit BB.

(The document above-referred to was marked Respondent's Exhibit BB and received in evidence.)

By Mr. Maiden:

Q. Mr. Monson, will you identify this document as being the Second Annual Report of the Northrop Aircraft, Inc., for the fiscal year to July 31, 1941?

A. Yes, sir.

Mr. Maiden: If the Court please, to save time I would like to offer this in evidence as respondent's Exhibit CC.

Mr. Wall: Same objection, your Honor.

The Court: Overruled. Admitted.

(The document above-referred to was marked Respondent's Exhibit CC and received in evidence.)

By Mr. Maiden:

Q. Mr. Monson, wouldn't you say that this growth of Northrop from January 1, 1940, no orders to October 1, 1940, [132] of \$20,617,586.14 was a very phenomenal growth?

A. That was, yes.

(Testimony of Claude M. Monson.)

Q. Don't you think that growth was indicated by the circumstances and conditions existing in the latter part of 1939 and the first part of 1940?

A. It may have been in the middle of 1940, but I would not say in the latter part of 1939, my personal opinion.

Q. Now, I believe that Exhibit R to the stipulation shows that as of December, 1939, the Consolidated Aircraft Company had given a sub-contract to this company of some \$658,472.00.

A. That is right.

Q. That Consolidated Aircraft Company was one of the big old-line established aircraft companies in the United States at that time.

A. Yes, sir.

Q. Wouldn't you say that that was an expression on the part at that time of the Consolidated Aircraft Company of confidence and faith in this new company to successfully operate as an aircraft manufacturing plant?

A. Yes, sir.

Q. And your company so regarded that business, is that correct, as an expression of faith?

A. Yes, sir.

Q. You at no time, Mr. Monson, doubted the ability of [133] your company to produce and produce well if given the opportunity, is that right?

A. No, I haven't doubted that.

Q. Now Mr. Monson I believe you stated a moment ago, I don't know whether in answer to one of my questions or whether it was on direct examination, that you had sent a telegram, your company had sent a telegram to the United States Navy Department explaining to them just what you could do and the necessity for the Navy to expand its

(Testimony of Claude M. Monson.)

program, and so on, etc. I am just wondering, can you produce that telegram for us.

A. I don't know. I will look. It was a teletype. It was not—it was after we were supposed to have this order. Our competitors had come and said that we could not produce that we sent this long teletype showing the number of people we had, the years of experience of the individuals who were working at our plant. I shall try to find it, yes.

Q. Would you think that that telegram, or a copy of that teletype would have been kept right in the records of the company?

A. I should think so, yes.

Q. I would appreciate if that would be produced.

A. I will do so, yes.

Q. Mr. Monson, I will ask you if it is not a fact in this case that this company organized and commenced business [134] at about the most propitious time that it could have commenced business?

A. Commenced business, yes.

Q. And didn't you think that Mr. Northrop—I will just confine it to you—didn't you feel when you first came with Northrop that by reason of the war conditions and the demand for military aircraft, that this corporation was almost assured of successful operation, as soon as it could get its financing done, its plant built and started in actual operations?

A. I have always regarded Mr. Northrop very highly. In March, when they asked me to come, it was because I liked to be associated with him as I knew his ability, and I was confident that we would succeed.

(Testimony of Claude M. Monson.)

Q. So you did have high hope for the future of this company? A. Yes, sir.

Q. I believe you stated that on March 4, 1940, in addition possibly to the \$760,249.16 sub-contract with Consolidated Aircraft Corporation, that there was no other business on the books at that time, with the exception of that one contract?

A. That is the only contract that was on the books.

Q. Now, Mr. Monson, as best you can recollect, how much business was in the stage of negotiation at that time, [135] but had not been finally determined?

A. To my knowledge, the only thing that we had bid on was on a small bomber design contract for the United States Navy. Now, that was still in the bid stage. The bid had been submitted.

Q. The bid had been submitted?

A. Yes. Outside of that I know of nothing else. I don't mean to imply here that we were not always out trying to get business.

Q. You were, of course. A. Sure.

Q. I understand that. I am afraid, Mr. Monson, that I misunderstood this: did I understand you to say, and don't get mad at me if I have misinterpreted your statement, because I don't intend to, but do I understand you to say that on March 4, 1940, this company had no expectation or anticipation at that time of getting this great amount of business, or any part of it? Is that a reasonable interpretation of your testimony, or not a reasonable interpretation of it? [136]

A. Well, I believe that everyone has a reason-

(Testimony of Claude M. Monson.)

able expectation of getting their share of the business that is in the field.

Q. And you did have that reasonable expectation?

A. Why, certainly. I don't think we would have even started the company if we had not had.

Mr. Maiden: I believe that is all.

The Court: Any redirect?

Mr. Wall: Yes, your Honor.

Redirect Examination

By Mr. Wall:

Q. Mr. Monson, you just testified in response to Mr. Maiden's questions, I believe, that as of March 4, 1940, the only bid you had submitted on other business, aside from the Consolidated contract, was a little small Army bomber design. I believe you testified on direct examination that you had at that time submitted a bid to the Norwegian Government on that order, isn't that correct?

A. Oh, yes, I am sorry. We did have the other bid in.

Q. Now, Mr. Maiden has referred you to some figures and further down on Respondent's Exhibit BB, coming down to a total in excess of \$20,000,000.00 as of November 1, 1940. Isn't it a fact that that total of over \$20,000,000.00 worth of business is made up of the various orders which were listed on Exhibit R and which you testified to on your direct examination?

A. Yes, sir.

Q. And I think you testified specifically as to each of those orders, as to the circumstances surrounding them and the outlook toward them as of March 4, 1940.

A. Yes, sir.

(Testimony of Claude M. Monson.)

Q. Mr. Maiden has also called your attention to some of the language in the prospectus, Exhibit 1-A. I should like to refer you to the portion just below that which Mr. Maiden read on page 5:

“The business of manufacturing, of course, is subject to many special hazards and unpredictable conditions, and is speculative in nature. It is impossible to protect against many of the risks which are inherent to the business.”

Will you likewise subscribe to that statement from your knowledge of the aircraft industry?

A. Yes, sir.

Q. Isn't it a fact when you left your position at the Douglas Company and went into this new venture with Mr. Northrop and his other associates, that you had, as you have said, high hopes of success because of the people with whom you were associating yourself, because of the position he had always stood in the aircraft industry?

Mr. Maiden: Just a moment, if your Honor please. I object to that as being leading. [138]

The Court: It is rather leading, yes, I think it is.

Mr. Wall: Very well. I will withdraw the question.

By Mr. Wall:

Q. Your hopes for the success of the Northrop Aircraft Company, Mr. Monson, you have testified was based largely upon your high regard for Mr. Northrop. It is true, is it not, that you had had rather close contact with him during the years preceding 1939, when you agreed to go into this new company?

A. Yes, sir.

(Testimony of Claude M. Monson.)

Q. Hadn't you had closer contact with Mr. Northrop at that time than most people in the aircraft industry had had?

A. You mean outside of our own company?

Q. Yes.

A. That is pretty hard to answer, of course.

Q. You had worked in companies or divisions of Douglas Aircraft which Mr. Northrop was largely in charge of, isn't that so?

A. Yes.

Q. Now, at the time when you left Douglas and took this position with Northrop Aircraft, were your feelings of hope for the success of the Northrop Division shared by your [139] employers at Douglas?

A. No, sir.

Mr. Maiden: Just a moment, your Honor. I object to this witness testifying to what the feelings were with respect to some other people of some other company.

The Court: Unless he knows what they thought, I think he would not be qualified to testify to that.

Mr. Maiden: If your Honor please, I believe Mr. Monson got his answer in. I would like to have it stricken. I believe it is improper.

The Court: It may be stricken. I didn't realize he had answered.

By Mr. Wall:

Q. Did your former employers at Douglas make any statements to you concerning your leaving their employ and going to Northrop Aircraft Company?

A. Yes, sir.

Mr. Maiden: Your Honor, I object to that. That would be hearsay. I don't think it is proper evidence.

(Testimony of Claude M. Monson.)

The Court: I don't think we are concerned particularly with what some other corporation thought about this new company.

Mr. Wall: Very well.

The Court: You may strike that answer, also.
By Mr. Wall:

Q. Going back to the status of world affairs in 1939 and 1940, Mr. Monson, as I recall it Germany invaded Poland on about September 1, 1939, is that correct, according to your recollection?

A. Well, I know I was still at Douglas when the invasion happened, and it was a very hot spell, and it was September sometime, the first part of September.

Q. Do you recall after the invasion and collapse of Poland, that we went through a considerable period in which there was no very great activity of a military nature in Europe?

A. I probably was not up close enough to that end of it. I don't recall.

Q. As I recall, the invasion of Norway came in April of 1940. A. That is right.

Q. And the invasion of the Low Countries came in May of 1940, isn't that true?

A. That is correct.

Q. Isn't it a fact that the main upswing in demand for military aircraft, particularly in this country, followed chiefly after the invasion of the Low Countries?

Mr. Maiden: Wait just a moment. Your Honor,

(Testimony of Claude M. Monson.)

that is a leading question. I am awfully sorry. I hate to keep [141] making these objections, but——

The Court: I think you are rather aiding the witness by that statement.

Mr. Wall: Very well, your Honor.

The Court: I will sustain the objection.

By Mr. Wall:

Q. You testified on cross-examination, Mr. Monson, that the Consolidated order that was placed with you in December of 1939 was, you felt, based in part at least on the faith in the organization, in your company. Do you think that the fact that you bid for that order at an estimated no-profit price, as you testified, likewise had anything to do with that acceptance?

A. Of course, it did. We are all on a competitive basis.

Mr. Wall: I have no further questions, your Honor.

Recross-Examination

By Mr. Maiden:

Q. Mr. Monson, I believe under the Norwegian contract it was stipulated that the Norwegian Government was to advance a great portion of the total contract price to the company at the time the contract was let, is that your understanding?

A. That is right, sir.

Q. And that the balance of the amount called for in the contract would be and was placed in an irrevocable letter of [142] credit with a New York Bank, is that your understanding?

(Testimony of Claude M. Monson.)

A. That is right, sir.

Q. I will ask you if it is not true that under the types of contract that the aircraft industry was receiving in the latter part of 1939 and first part of 1940, and for that matter all during the rest of the war, for the manufacture and furnishing military aircraft to the United States Government and foreign governments, if it was not the custom that the purchaser would advance a substantial sum of the contract price to the producer, and then as the planes and parts had been delivered to them pay the balance of the contract price?

A. That is correct on foreign contracts and commercial contracts the usual advance is somewhere between 20 and 30 per cent, with the payment of the difference as each aircraft is delivered. With the United States Navy in those days, they had a base price bid, and the only reimbursement that you got from the Government was progression payments which were allowed for military contracts, based on the expenditures for actual material and labor, but which did not include engineering or other services, on which they would advance, so the result is on any contract the contractor almost can be sure, depending on the size of it, of being paid 50 to 60 per cent of the bid price before he gets anything out.

Q. So your answer is that in contracts you knew that [143] you would receive a certain percentage of the contract price in advance as working capital for the company in the production of that contract.

A. On foreign business usually, yes.

(Testimony of Claude M. Monson.)

Q. Mr. Monson, wouldn't the fact that the Consolidated Aircraft Corporation, which I believe you testified was one of the larger members of the aircraft industry in the United States, gave a sizeable subcontract to Northrop, which was a new corporation, in December, 1939, indicate that Consolidated had orders at that time beyond its capacity to produce?

A. Not necessarily. Subcontracting is being done today and has always been done. That does not mean you have not got time to produce them in your own organization, but you may not have the proper facilities or you may not have the floor space required.

Q. That would go to the capacity to produce, though, wouldn't it, those factors would go to the capacity to produce?

A. I would go further and say that there is not an aircraft company in the United States that produces 100 per cent of its airplane, even in the worst times.

Q. Even in the worst times?

A. That is right.

Q. Would you say, Mr. Monson, that in the latter part of 1939 and the first part of 1940 that the capacity of the [144] existing aircraft industry was not abreast of the then demand? Is that correct?

A. That is not correct. In the latter part of 1939 your aviation industry had room to take on orders, and thus the high competition that we ran into with the Navy, the Iraq Government and the Norwegian

(Testimony of Claude M. Monson.)

Government, when we had a chance to go after the business.

Q. In other words, that was an actual demand for military aircraft?

A. There was, small orders of 20 or 25.

Q. You felt that there was plenty of room for growth and expansion of the aircraft industry at that time, did you not, Mr. Monson?

A. We felt that, if I may reiterate again, we felt that there was room for a small aircraft company devoted to the design of military aircraft. We had no anticipation of going beyond the original plant site that we built and retaining the number of employees that we had agreed upon.

Q. But didn't you think that the potential demand and probabilities of future demand was so strong as to justify a belief in the aircraft industry as it existed in the United States in the latter part of 1939 needed to expand its capacity to take care of that probable future demand, which all the events of that time seemed to prophesy.

A. That is right. But my personal opinion is this, [145] when we first started the organization we thought that was what we were going to do, but we didn't know that we were going to go beyond that organization to the point where employees became numbers rather than individuals.

Mr. Maiden: I believe that is all.

Mr. Wall: May I ask the witness one more question?

The Court: All right.

(Testimony of Claude M. Monson.)

Redirect Examination

By Mr. Wall:

Q. Mr. Monson, were all of these orders which were on the company's books up to October 22, 1940, which are in the list attached to Exhibit R which you have looked at, were those the fixed price type of contracts?

A. Yes, sir, I am sure that they were.

Q. Exhibit R has a list attached thereto.

A. Yes, sir, they are all fixed price contracts.

Q. None of those were the cost plus a fixed fee type?

A. The cost plus fixed fee contract did not come into effect until 1941, if my memory serves me correctly.

Recross-Examination

By Mr. Maiden:

Q. Your contracts with the British Government were on very liberal terms, weren't they, liberal returns?

A. As to the terms of the contract?

Q. Yes. [146]

A. We produced the Spaulding Airplane for them.

Q. I say they were quite liberal returns that allowed you a nice margin of profit for the company?

A. We did anticipate a nice margin of profit, yes, sir.

Q. As a matter of fact as certainly as of October 10, 1940, you anticipated and expected to make

(Testimony of Claude M. Monson.)

on the orders you had a profit of in excess of \$4,000,000.00 by the end of that year, didn't you, Mr. Monson?

A. Yes, but may I go further and say that was covered——

Q. He did explain that. A. He did.

Q. I believe your orders had reached a high of some \$70,000,000.00 up to July 31, 1941, isn't that correct, Mr. Monson?

A. I wouldn't remember the exact date. You said 1941. It is one of the reports.

Q. In excess of \$70,000,000.00, is that right?

A. That is right.

Mr. Maiden: I believe that is all, your Honor.

Mr. Wall: No further questions.

The Court: That is all, Mr. Monson. We will adjourn until 2:00 o'clock.

(Witness excused.)

(Whereupon, at 12:30 p.m., a recess was taken until 2:00 p.m. of the same day.) [147]

Afternoon Session, 2:00 p.m.

The Court: Call your witness.

Mr. Wall: Mr. Carl L. Barnes.

Whereupon,

CARL L. BARNES

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: State your full name, and your address, please.

(Testimony of Carl L. Barnes.)

The Witness: Carl L. Barnes, 639 South Spring. That is my business address. Do you want the home address, too?

The Clerk: That is not necessary. You may be seated.

Direct Examination

By Mr. Wall:

Q. Mr. Barnes, what is your business or occupation? A. Investment securities.

Q. Are you employed by or a member of an investment securities firm at the present time?

A. Yes, I am a member of the Los Angeles Stock Exchange and I am employed by Morgan & Co.

Q. Were you in the securities business in the latter half of 1939? [148] A. I was.

Q. At that time were you associated with the securities firm of White, Wyatt & Co.?

A. Correct.

Q. In Los Angeles? A. Yes.

Q. What was your position in that firm then at that time?

A. I was manager of the stock department.

Q. Were you familiar with a transaction whereby Mr. T. T. Ellsworth in the latter part of 1939 exchanged his rights under a certain contract with Northrop Aircraft Company for certain shares of Duvall Texas Sulphur Company which were formerly owned by Mr. A. H. Smith of Houston, Texas? A. I am.

Q. Did you take part in that transaction?

A. I did.

(Testimony of Carl L. Barnes.)

Q. In what way did you participate in the transaction, Mr. Barnes?

A. I was the party that brought the two together.

Q. How did you first become interested or involved in the transaction?

A. Well, I heard of this management contract that Ellsworth had for sale and contacted him with the idea that I might be able to dispose of it. [149]

Q. Can you state approximately when you first heard of that?

A. I would say during the latter part of August or the first part of September, 1939.

Q. And after you contacted Ellsworth and said that you might be able to dispose of it, what did you do then?

A. I contacted a friend of mine by the name of Smith with the idea of trying to get him to buy it.

Q. Is that Mr. A. H. Smith of Houston, Texas?

A. Mr. A. H. Smith, yes.

Q. Had you previously met Mr. Smith?

A. Yes, I had.

Q. Did you have any reason to believe at that time that Mr. Smith might be interested in such a contract?

A. Yes, I did. I had known Mr. Smith for several years, and from time to time he became interested in aviation securities and particularly ones in Southern California.

Q. Had he made statements to you to the effect that he was interested in that type of security?

(Testimony of Carl L. Barnes.)

A. Yes, he did.

Q. What was Mr. Smith's initial reaction to your proposal, Mr. Barnes?

A. Well, he was very much interested in the newly formed corporation of Northrop and Company, and when I indicated to him that I might be able to pick up a management [150] contract, he showed a good deal of interest.

Q. Did he make any statements to you during your contacts with him concerning his reasons for buying any such contract, besides the one you have already mentioned?

A. Yes, he did. He was very much interested in Jack Northrop himself.

Q. I see. Do you know whether he was personally acquainted at that time with Mr. Northrop?

A. I don't believe so.

Q. Can you state approximately how long the negotiations looking toward this transaction continued?

A. I would say approximately 90 days.

Q. And in general of what did the negotiations consist?

A. Bartering back and forth as to price.

Q. Was Mr. Smith in Texas during the entire period of negotiations?

A. Not the entire period. He was here when the negotiations started, and when they were finished he was in Texas.

Q. Some of the negotiations were personal and

(Testimony of Carl L. Barnes.)

others were carried on by correspondence, is that correct?

A. Oh, yes. As a matter of fact there was a good deal of correspondence, telephone calls, telegrams, et cetera, that lasted over a period of several months.

Mr. Wall: That is all. [151]

Cross-Examination

By Mr. Maiden:

Q. Mr. Barnes, do you know why Ellsworth was interested in selling his Northrop contract?

A. Why, I would answer that in the following way: I believe Ellsworth wanted to raise some money.

Q. It is a fact, isn't it, that Mr. Ellsworth at that time was in very strained financial condition, or under the compulsion of raising some cash money?

A. I don't know that.

Q. Did he tell you that?

A. No, he did not.

Q. But you did understand that he wanted to raise some cash money and that is the reason why he was interested in selling his Northrop contract?

A. That is right.

Q. Do you know whether Mr. Smith is living or dead now?

A. He is dead.

Q. Mr. Barnes, what was the price at which the parties determined—strike that. What price did the parties determine that the Duvall Texas stock was worth at the time of the exchange?

A. Approximately \$7.00 a share.

Q. Would you say that that represented a fair

(Testimony of Carl L. Barnes.)

market [152] value at that time of the Texas Duvall stock, \$7.00 a share?

Mr. Wall: If your Honor please, I object to that as calling for a conclusion of the witness. I have not qualified Mr. Barnes as an expert. I have no objection to Mr. Maiden's calling him as his own witness for that purpose, but I do not think it is proper cross-examination.

Mr. Maiden: If your Honor please, he has answered the question——

The Court: I don't know. He has not been qualified. He said he is in the securities business, and that is hardly enough to qualify a man without more, I think.

By Mr. Maiden:

Q. Mr. Barnes, I will ask you if it is not a fact that Mr. Smith, when this \$7.00 figure was arrived at as the value of the Texas Duvall stock, if Mr. Smith did not give Mr. Ellsworth a guarantee that that would be and that that was the fair market value of the Texas Duvall stock?

A. Well, there was no guarantees of any kind given.

Q. What was your understanding in that respect, Mr. Barnes?

A. In regard to the amount of money involved or——

Q. In regard to Mr. Smith assuring Mr. Ellsworth that that \$7.00 represented the fair market value of the Texas Duvall stock, and that the Texas Duvall stock would be worth \$7.00 a share. [153]

(Testimony of Carl L. Barnes.)

A. Your question is not exactly clear. However, as far as price, the last sales were a matter of record at that time.

Q. Was it on the basis of those last sales that you arrived at the \$7.00?

A. Yes, it was. Duvall Texas Sulphur is listed on the New York Curb, and transactions occur almost daily, but not always.

Mr. Maiden: I believe that is all, your Honor.

The Court: Is that all, Mr. Wall?

Mr. Wall: May I ask one question, your Honor?

The Court: Yes.

Redirect Examination

By Mr. Wall:

Q. Mr. Barnes, you testified that you understood that Mr. Ellsworth wanted to raise money. Did Mr. Ellsworth make any statements to you concerning that matter prior to or during the negotiations leading up to this exchange?

A. Well, anyone that wants to dispose of a contract of that type, I immediately assume that he wanted to raise money for some purpose.

Q. Did he make any statement to you concerning his need for money? A. No, he didn't.

Mr. Wall: That is all, your Honor. [154]

* * * *

Mr. Wall: If Your Honor please, I very greatly appreciate the indulgence of Court and counsel. The witness is now here and I will call Mr. B. P. Lester. [155]

Whereupon,

B. P. LESTER

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: B. P. Lester, 621 South Spring Street, Los Angeles, California.

Direct Examination

By Mr. Wall:

Q. What is your business or occupation, Mr. Lester?

A. I am the president of Lester & Company, registered security dealer, engaged in the underwriting and distribution of corporate and municipal securities.

Q. How long have you been engaged in the securities business, Mr. Lester?

A. Between 24 and 25 years.

Q. Your firm of Lester & Company was one of the underwriters of the Class A Common stock of Northrop Aircraft, Inc., which was offered to the public in 1939, was it not? A. It was.

Q. Was your firm of Lester & Company one of the original group of underwriters who considered underwriting that stock?

A. No, it was not one of the original group. [156]

Q. Do you recall approximately when Lester & Company became a member of that group?

A. Well, I think it was the end of May or the first part of June, 1939.

Q. What were the circumstances under which

(Testimony of B. P. Lester.)

Lester & Company came into the group of underwriters at that time?

A. I believe the original group included two other security dealers who when the registration statement was filed just before the issue was to be granted decided not to undertake the distribution of the securities. E. H. Rollins & Sons and O'Melveny, Waggenseller & Durst were the two firms that had withdrawn. I was approached by an officer of Banks, Huntley & Company, I think it was late in May, 1921.

Q. 1939? A. May, 1939. [157]

Q. Now, Mr. Lester, it is in evidence here that the original underwriting agreement, which was dated June 17, 1939, provided for the purchase and distribution, on an underwritten basis, by the underwriters, of 200,000 shares of Northrop Class A Common Stock, also for the appointment of the underwriters as the exclusive agents of the company, for the sale of an additional 200,000 shares on an agency basis. You recall that, do you?

A. That is my recollection, yes.

Q. It is further in evidence that that underwriting agreement was amended under date of August 13, 1939, to cut down the number of agency shares, from 200,000 to 50,000. Do you recall that?

A. That is correct.

Q. Will you please state the circumstances, under which the total amount of stock to be distributed, was thus reduced from 400,000 to 250,000 shares?

(Testimony of B. P. Lester.)

A. Well, there were six underwriters, as I recall it, the Banks, Huntley Company and ourselves, O'Brien, Potter & Co. of Buffalo, Cohu, Torre & Jorgenson of New York, Air Investors, which was an investment trust, with a portfolio of aircraft securities, and as I recall it, Hartley, Rogers & Co. After the registration statement became effective, we attempted to distribute the stock. It went very badly to begin with, and negotiation was undertaken with Mr. Floyd [158] Odlum, President of the Atlas Corporation, which resulted in a subscription by the Atlas Corporation, for, I think it was 30,000 shares of stock, and the number of warrants, 6,000 public warrants, that were offered with those shares, and we underwriters gave up to Atlas Corporation, our proportion of underwriters' warrants that related to the shares to be sold, and which we were to receive as part compensation, plus some additional ones that related to other shares, that is, underwriters' warrants. That gave the offering of the stock sufficient appeal so that we were able to continue the selling, but when we had gotten to about 200,000 or 225,000 shares, it was obvious that it would be perhaps not impossible, but very difficult to go beyond, distribute beyond the 250,000 shares, because we were getting re-purchases almost as fast as we were getting sales, and we negotiated with the officers of the company, and the promoters of the enterprise, to have a revision of their initial program. Their initial program called for the expenditure of about \$2,000,000, and it was felt that that

(Testimony of B. P. Lester.)

amount of money was the smallest amount that they felt would make them readily competitive, but that they could review their whole program and start in on a smaller scale with the amount of capital which could be raised, by the sale of 250,000 shares, that was \$1,250,000 in the company, and that was accomplished, and the offering was cut down from 400,000 [159] to 250,000 for those reasons.

Q. Mr. Lester, you mentioned this Atlas Corporation purchase of 30,000 shares. Did the Atlas Corporation buy those shares from the underwriters?

A. Well, I don't recall the exact way that worked out, except that Atlas was willing to purchase the shares, provided they got the securities, and it would not become an underwriter. Now, I don't know whether they purchased on that——

Q. I show you Exhibit No. 1A, page 15, where it is said that Atlas Corporation has purchased from the underwriters, 6,000 underwriters' units.

A. That is correct.

Q. That would comprise 30,000 shares and 6,000 warrants, is that not correct?

A. That is correct.

Q. What was the price that Atlas Corporation paid for those?

A. Well, they paid, as I recall it, the net price to the company, which was \$5.00 a share.

Q. And they paid that to the underwriter; was that the same price that you had to pay the company for those shares?

A. That is correct.

(Testimony of B. P. Lester.)

Q. The price at which the underwriters offered the [160] shares to the public, however, I believe it is in evidence here, \$6.00 for each share, is that not true? A. That is correct.

Q. Did your firm of Lester & Company deal in Class A common shares of the Northrop Company, during the period from July 31, 1939, to December 31, 1940, Mr. Lester? A. We did.

Q. Were you a director of Northrop Aircraft, Inc., during this period of distribution of the Common Class A to the public?

A. Yes, I was a director until, I think, 1942 or 1943. I think it was 1942 when I resigned.

Q. When did you first become a director?

A. At the inception of the company.

Q. As a director of the corporation, Mr. Lester, were you generally familiar with its business affairs? A. I was.

Q. And, with its financial condition and structure? A. I was.

Q. And, with its plans for future activities?

A. I was.

Q. Its prospects for future business?

A. I was.

Q. Now, do your activities in the securities business, Mr. Lester, involve the determination of the value of [161] securities of various types?

A. Yes.

Q. Does that include stocks as well as bonds?

A. That is correct.

(Testimony of B. P. Lester.)

Q. Does your experience in that connection include the valuation of aircraft securities?

A. Yes, it does.

Q. Securities of new enterprises?

A. That is right.

Q. Would you tell us in what way those activities, in your opinion, involve valuation of securities.

A. Well, for the past 24 years I have been in the underwriting end of the securities business. It is an essential part of our work that we arrive at the dollar valuation of the securities, in connection with our purchases of securities all the time. [162]

Q. Do your activities involve the valuation also in dealing with securities for your own account and for the account of your firm?

A. That is correct.

Q. Your activities involve that type of valuation in advising clients as to investments?

A. It does.

Q. Would you please give me briefly, Mr. Lester, the elements of valuation which you customarily consider important in valuing a common stock.

A. Well, I would say the assets of the corporation, the earnings, the management and its experience, background, the history of the enterprise, the nature of the business, of the field in which the company is to be engaged or is engaged. There are a good many others. I think those are the principal ones.

Q. I think that is sufficient, Mr. Lester. Were you familiar with the arrangements which were

(Testimony of B. P. Lester.)

made in June of 1939 for the issuance of certain Class A and Class B shares to the promoters of the Northrop Aircraft, Inc., namely, Mr. Cohu, Mr. Northrop, Mr. Irving, Mr. Bellande, Mr. Stephens and Mr. Ellsworth? A. I am.

Q. Have you made a study of the facts in this case, as set forth in the stipulation which is filed herein and in the [163] exhibits attached thereto?

A. I have read the stipulation and exhibits, yes.

Q. Have you read the Articles of Incorporation of the Northrop Aircraft, Inc.? A. I have.

Q. And particularly that provision of Article 5 relating to the restrictions of the Class B shares?

A. Yes.

Q. Have you read the contracts dated June 17, 1939, between the company and Messrs. Cohu, Northrop, Irving, Bellande, Stephens, particularly relating to the issuance of Class A and B shares to these promoters?

A. And the amendment to the contract. Is that the contract which was amended at a later time?

Q. I think you are thinking of the underwriting agreement. A. That is correct.

Q. That is, for the sale. A. That is correct.

Q. I am speaking of the agreement between the company and each of the various promoters.

A. I have, yes.

Q. Have you read the Corporation Commissioner's permit relating to issuance of the Northrop stock? A. I have. [164]

Q. Which is set forth in the prospectus attached

(Testimony of B. P. Lester.)

as an exhibit to the stipulation? A. I have.

Q. And have you noted conditions B, C and D in that permit relating to restrictions on the shares to be issued to the promoters? A. Yes, I have.

Q. Are you familiar with or have you read the agreement between the company and the promoters dated as of November 30, 1939, whereby the promoters waive their rights to dividends and waive their rights to participate in assets, pursuant to the Corporation Commissioner's permit?

A. I have.

Q. Were you present in the court room during the testimony of Mr. Claude M. Monson with respect to the business conditions and prospects of the company as of March 4, 1940? A. Yes, I was.

Q. Have you reviewed the balance sheet of the company as of February 29, 1940, attached to the stipulation as Exhibit 18-S? A. I have.

Q. Are you familiar with the information set forth in the stipulation in Paragraphs 41 and 43?

A. I am.

Q. Are you familiar with the information which is set [165] forth in Exhibit 19-T of the stipulation regarding the number of unrestricted or public Class A common shares which were purchased and sold by your firm of Lester & Company during the period from November 9, 1939, to March 8, 1940, and the prices at which those shares were purchased and sold? A. I am.

Q. Now, Mr. Lester, for the purpose of answering the question which I am about to put to you, I

(Testimony of B. P. Lester.)

would like to give you the following definition of the term fair market value: By the term fair market value is meant the fair value of property in money as between one who wishes to purchase and one who wishes to sell, that is, the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price will trade, neither being under any compulsion to trade, and both having a reasonable knowledge of the facts. I caution you that the prices at which stock is sold on an over-the-counter market or stock exchange are not necessarily controlling in fixing the fair market value of the stock, although such prices are a factor that should be considered with other factors. I caution you also that sales made under peculiar and unusual circumstances, such as sales of small amounts or sales in a restricted market, are not necessarily controlling in fixing the fair market value. In formulating your opinion and in answering the question which I am about to put to you, I will ask you to put yourself back at March [166] 4, 1940, disregarding facts occurring after that time and limiting yourself to the facts which were known on or before that date or which could have been reasonably anticipated. Now, Mr. Lester, what, in your opinion, was the fair market value on March 4, 1940, of the Class A common shares of Northrop Aircraft, Inc., which were issued to Mr. Northrop, Mr. Cohu, Mr. Irving, Mr. Bellande and Mr. Stephens, as promoters of that corporation?

A. I do not think they had any value.

(Testimony of B. P. Lester.)

Q. What, in your opinion, Mr. Lester, was the value on March 4, 1940, of the Class B common shares of Northrop Aircraft, Inc., which were issued to the same gentlemen as promoters of Northrop Aircraft, Inc.?

A. I do not think they had any value.

Q. Will you please state the reasons on which you base the opinions which you have just expressed?

A. Well, I think the two principal reasons are these: The restrictions under which these shares were issued, coupled with the fact that the five men who received the shares were the basis upon which this whole promotion was being made. Mr. Northrop, Mr. Cohu, Mr. Irving, Mr. Bellande and Mr. Stephens were all men with unusual experience in the aircraft industry. Northrop was an engineer of experience and very high standing in the industry, who contributed many very unusual technological advancements to the industry, both [167] in the design of the airplane itself and also in the structural design of the aircraft components. I think he is responsible for the so-called monocoque construction of the wing, which braces the entire wing from the inside, eliminating what we used to call struts in the old airplanes, making a very clean design. Along with that fact he was the designer who had developed a great many of the very advanced models for the aircraft as well as certain parts of their planes. Mr. Cohu had a rather long business experience in aircraft. As I recall it, he had been president of

(Testimony of B. P. Lester.)

North American Aviation, a company which was one of the earliest in the field of aviation, he was a director of T.W.A., and the organizer and one of the directors of Air Investors, Incorporated, with a wide business experience in aircraft manufacturing and aircraft operation. The other three men were experienced in aircraft. Mr. Irving had had a very considerable shop experience in connection with shop practices in aircraft manufacturing and was a graduate of a technical school, and his value was very great, because of his experience in shop practice and techniques in aircraft manufacturing. The other two men were two of the most experienced fliers in the country. Mr. Bellande had, I think, more hours than any other transport pilot in 1939, was one of the holders of the Congressional Air Mail Medal and really was an experienced pilot both from the standpoint of operation of aircraft [168] generally and in aircraft care in operation. He was considered to be an ideal prospect for this pilot duty. Stephens had had a wide experience in aeronautics. He was a pilot who had flown with Richard Halderman around the world and was well known as a pilot, and he was one of the type of people who lent the prospect of stability to this enterprise. I listened to Mr. Monson's testimony this morning with reference to the experience in making that aircraft and I recall a good many of the things that he mentioned. So I think we felt that with a group of that kind and the peculiar experiences of that group and with that group tied in there was a very

(Testimony of B. P. Lester.)

substantial financial prospect for the success of the company, that it was a proper thing to offer the public the securities in the enterprise. It is that particular group, in my opinion, which was responsible for the marketing of the securities. With that group we were able to sell the stock at the offering price and sell it rapidly enough to distribute more stock than we required for the market. But it is my opinion that if any one of these gentlemen had attempted to market his securities, that that fact alone would have completely dissipated public interest in the shares, not only of the public holding but in the shares that he would be selling. I can't conceive how the informed investor would have paid anything for the stock of those men. He might that somebody would pay the market value of the stock, but if one [169] of those gentlemen sold out, in my opinion, it would dissipate the entire enterprise, especially if it had been understood by the public that we were offering this Northrop stock. That is all there was that the company was offering for sale. The company did not have anything except a batch of papers, and in 1940 the company was a little worse off, in my opinion, than it was when it was started. They had used more money than they planned in this plant, and that is demonstrated by the balance sheet of July 19, 1940. They put it in promotional expense and in plant, and if any work had been offered to them that did not result in their getting advance payments or other help of that kind, it would have been difficult for me to see how

(Testimony of B. P. Lester.)

they could have taken the work. The financial crisis for the company came about two months later.

Q. Two months later than what?

A. Than March, the early part of March.

Q. March 4th?

A. It came the early part of May, as I recall it, when the company started up its work. It had invested its capital in fixed assets, and found itself without working capital to meet a payroll, and without a credit. It required considerable negotiation, as I recall it, in the early part of May, to establish a credit line with the Bank of America and the Security-First National Bank of a sufficient amount [170] of money to carry them over that crisis. Fortunately by that time they had acquired the Norwegian contract, which was the backlog of business which made such bank financing possible.

Q. May I ask you there, Mr. Lester, you mentioned this crisis which occurred about two months after the early part of March. In your opinion, was that crisis foreseeable and in the making on March 4th or not? I ask you that because your opinion must be based on the factors that were known or could reasonably be foreseen.

A. Well, I thought it was very evidently a future possibility.

Q. Your own personal opinion at that time was that the crisis——

A. My personal opinion was that the program that the company was engaged in was greater than

(Testimony of B. P. Lester.)

the amount of capital started with could adequately service, and that there was some danger ahead.

Q. Did you consider other factors in arriving at the opinion you have expressed, Mr. Lester?

A. Well, there are all these factors, the fact that the stock was in this escrow and that the corporation Commissioner's permit—under that there was the disabilities with reference to earnings and dividends, and in the event the company had failed no recapturing of any part of the assets, that is, it [171] all had to go to the public stockholders.

Q. Did you give consideration to the earnings history of the company at that time?

A. Well, it didn't have any.

Q. Did you give consideration also to the order position of the company at that time, the amount of orders that it had on its books then?

A. Yes, I did.

Q. Did you give any consideration in arriving at your opinion, Mr. Lester, to the size of the stockholders involved, the fact that, according to the stipulation Mr. Northrop had 15,384 Class A shares and 38,461 Class B shares, Mr. Cohu had seventy-six hundred odd A shares and eleven thousand five hundred odd B shares; that Mr. Irving had forty-six hundred odd A shares and ten thousand seven hundred odd B shares; and the fact that Messrs. Bellande and Stephens had fifteen hundred some A shares and twenty-three hundred some B shares?

A. Well, those were a great deal larger blocks than were being traded in on the market. Even if

(Testimony of B. P. Lester.)

they had been free from restrictions and the market was not aware of the fact that principal officers of the company were selling it, those were very much larger blocks than would have brought anything like the market price for the number of shares traded in the early part of March. [172]

Q. You have stated that, in your opinion, neither the Class A nor the Class B shares issued to those men had any fair market value. Are there any different reasons applicable to the Class A shares that are not applicable to the Class B, or vice versa, in your opinion, Mr. Lester?

A. No. I felt and I am sure that every other underwriter felt that we had an unqualified obligation for those men to stay with the enterprise.

Q. There was an unqualified obligation on those men?

A. Absolutely. We were making two markets for one on the strength of their living up to their obligation.

Q. In arriving at these opinions as to value which you have expressed, Mr. Lester, did you give consideration to the transaction which is described in the stipulation in Paragraphs 52 to 60, inclusive, in which Mr. T. T. Ellsworth in November, 1939, exchanged his contract or his contract rights under his agreement with the company for 2200 shares of Duvall Texas Sulphur Company owned by Mr. A. H. Smith of Houston, Texas?

A. I am familiar with that transaction.

Q. What weight, if any, did you give to that

(Testimony of B. P. Lester.)

transaction in formulating your opinion as to the value of the stock?

A. Well, so far as Ellsworth was concerned, it was entirely different for him to have dropped out of the [173] enterprise. He was a bond salesman employed by Banks, Huntley & Company who had acted as a go-between between those groups and had done some work in connection with the proposed plant location, and it was not contemplated that he even had any interest in the company at all, and as I recall it, he had no official position with the company.

Q. Did Mr. Ellsworth have any background in the aircraft industry at that time?

A. I don't think he had up to that time had any experience. In relation to his contract, which took this first stock out in November, 1939, I will be very frank to state, from expressions I have heard, he never had to pay anything for that contract.

Q. In arriving at the opinions which you have expressed, Mr. Lester, did you give consideration to the prospects as of March 4, 1940, for future earnings of the company, as you saw them?

A. Yes, I think I did.

Q. And in arriving at your opinion with respect to the Class B shares, did you give consideration to the option in the company to repurchase certain of the shares of Mr. Northrop, Mr. Cohu and Mr. Irving, under certain conditions?

A. I did, yes.

Q. For 25 cents a share?

A. I did. [174]

(Testimony of B. P. Lester.)

Q. In connection with the B shares, did you give consideration to the restrictions of those shares under the Articles of Incorporation, as well as the restrictions imposed by the Corporation Commissioner's permit on both the A and B shares?

A. I did.

Mr. Wall: I have no further questions.

The Court: Cross-examine.

Cross-Examination

By Mr. Maiden:

Q. Mr. Lester, you mentioned the Atlas Corporation as having taken over a certain block of these shares from the underwriters in 1939. What was the nature of the business of the Atlas Corporation?

A. It is an investment trust. The head offices were then, I think, Jersey City, New Jersey.

Q. Is that a large concern?

A. Yes, it is one of the largest investment trusts in the country, I believe.

Q. And is it your understanding that the Atlas Corporation in taking over this block of stock did so for investment purposes, and not for resale to the public?

A. That is correct, yes.

Q. Now, is it true, Mr. Lester, that at the time the underwriting agreement was amended so as to reduce the number [175] of shares to be taken down by the underwriters, that at that time the underwriters made firm their undertaking with respect to the reduced number of shares?

(Testimony of B. P. Lester.)

A. As I recall it, yes, they went firm on the 250,000.

Q. Prior to that time you could have gotten out of the undertaking, depending upon conditions?

A. That is correct, yes.

Q. Now, Mr. Lester, do you profess to be a man of experience and knowledge of the aircraft industry?

A. Well, with reference to financing of the aircraft industry, I have participated, I think, or my firm has at my suggestion in the securities of almost all the aircraft companies except Douglas. We were in the original and in the two subsequent pieces of financing by Lockheed. We were in the Martin financing. We were in the Consolidated financing. We were in the Vultee financing. We were in the Grumman financing. We participated in the distribution of both Brewster and Bell-Aircraft, and also in a good many of the airline stocks we participated.

Q. But aside from that phase, though, you do not profess to have any experience in the operation of aircraft manufacturing plants?

A. Yes. I was vice-president in charge of financing of Aurora Aircraft Corporation for three years during the war. That was the largest subcontract— [176]

Q. What war was that?

A. This past war.

Q. I am speaking now as of 1939 and March 4, 1940.

(Testimony of B. P. Lester.)

A. No, I had never had any experience with aircraft companies prior to the war, this present war.

Q. Either in financing or otherwise?

A. Oh, yes. I had experience in financing.

Q. In finance?

A. Yes. I went back over that this noon. We were in the Lockheed financing, as I say, two pieces of financing for Lockheed, one, I think, was three years before 1939, came in 1936, I believe, and one in 1938. The Bell financing, Bell Aircraft came before this and Martin came before this. Consolidated came before it. We were one of the underwriters of the Grumman stock, and handled the distribution through some 14 or 15 dealers on the Pacific Coast, and that was in 1938, I believe, 1937 or 1938. We were in the Vultee convertible and preferred financing. All of those came before Northrop. The only one that came after was the distribution of Aurora Aircraft stock.

Q. Mr. Lester, what, if you know, was the trend in the aircraft industry in the United States on March 4, 1940? Was it upward or downward?

A. You mean the trend in the——

Q. In the business. [177]

A. ——volume of business and so on?

Q. Yes, sir.

A. I think it was a forward trend.

Q. You think it was a forward trend?

A. Yes.

(Testimony of B. P. Lester.)

Q. Would you say that that trend commenced as early as the latter part of 1938?

A. I think the trend commenced before that. Certainly for the major plants it commenced substantially before that. Lockheed had gotten over the hump in 1935. The purchasing commissions of the French and British had commenced to arrive, I think, it was in 1938, in the summer of 1938. I think there was a forward trend in the industry that began when it recovered from the 1929 depression, began in through 1932, '33, and '34 and carried all through that period.

Q. Would you say that the aircraft industry, or did you so regard it, as being a permanent and necessary part, leaving aside the idea of a war breaking out, of American industry and commerce?

A. You mean in 1940?

Q. In 1937, 1938 and so forth.

A. It certainly was a definitely established industry in America.

Q. And it was an industry that was growing and expanding? [178]

A. It was.

Q. Would you say, Mr. Lester, that the Northrop Aircraft Company was organized at a strategic time, so to speak, from the standpoint of being able to expand and operate profitably and at the most propitious moment in the history of American aircraft?

A. No, it was too late. It should have been five years earlier.

Q. It should have been five years earlier?

(Testimony of B. P. Lester.)

A. The major companies were established in fields in the industry considerably before 1939, and, in my opinion, the danger that Northrop had was the kind of competition that it got from the companies that had already carved out a slice of the business for themselves, like the Douglasses and the Martins.

Q. Mr. Lester, what interested you in becoming an underwriter of this company in the early part of 1939? A. What interested me?

Q. Yes.

A. I thought we were going to have a war and I thought we were going to have a larger volume of aircraft business in this country than we had ever seen before.

Q. Did that turn out to be true?

A. Oh, yes, no question about it. And I thought that with the capacity of Northrop and his group of people, that [179] they would get a share of that business.

Q. Did that turn out to be true?

A. It did.

Q. And did it surpass your expectation?

A. No, it did not.

Q. Would you say then, Mr. Lester, that in the latter part of 1938 and first part of 1940—the latter part of 1939 and first part of 1940, would you say that the prospects for the successful and profitable operation of this business were good?

A. Yes, they were good, in my opinion.

Q. Would you say that they were better in

(Testimony of B. P. Lester.)

view of the national situation than they would have been in ordinary peace times?

A. I think so, without question.

Q. Did you consider, Mr. Lester, that the obtaining by the Northrop Company of the subcontract from Consolidated Aircraft and obtaining the Norwegian contract had the effect of really establishing Northrop in the business?

A. Well, those were the first two pieces of business that the company had been able to attract up to that time. It is a little hard for me to tell what you mean by establish. At that particular time, in that particular period, there was rather wide expansion, there was considerable experience about aircraft and the placing of contracts. There was a very [180] small amount of actual work placed. I imagine it was attributable to the fact that the planning had not taken form yet.

Q. But this big competitive business was there?

A. It was still out in front.

Q. And it turned out better than you really expected it to turn out, didn't it? It turned out all right?

A. Well, I think Northrop got its share when the thing came along. I think the disappointing fact was that it did not come along a little sooner.

Q. You mean that the money did not come along a little sooner?

A. Yes, I think Northrop could have handled that volume of work sooner than it did.

Q. So that you would say then that on March

(Testimony of B. P. Lester.)

4, 1940, that the anticipation of the rapid growth of Northrop on an eventually profitable basis was high and based upon sound reasoning?

A. Well, I hadn't lost my faith in myself in the effectiveness of that team.

Q. In other words, you put great value yourself in Northrop at that time and in an investment of Northrop at that time?

A. That is right. We had sold the stock, and there was still steady buying of it all during that period of time. [181] We sold the stock was there wasn't any Northrop, there was just a bunch of papers, and we sold it on the ability of those five men, and even though their planning was a little heavier than their penny box during that earlier stage, I don't think—I know I didn't and I don't think the other underwriters lost faith in their ability, that group, to get its share of the business and do it for a profit.

Q. In other words, you felt that this team would attract business in the aircraft industry, under the demand conditions of that time, like honey would attract flies, so to speak?

A. We expected to attract business, all right.

Q. And they did attract business?

A. It did.

Q. And most substantial business?

A. It did.

Q. Mr. Lester, did your company retain any of the shares in Northrop?

A. For permanent investment of the firm?

(Testimony of B. P. Lester.)

Q. Yes.

A. No, I don't think so, but trading in the shares actively, there were times when we were long a substantial amount of shares. We would be long a substantial number of shares from time to time, and then that position would [182] reduce. It is not our business. We are not an investment trust. We are a merchandiser of securities.

Q. I was just asking you individually. Did you purchase any Northrop stock?

A. As I recall it, I owned some stock at some period of time in there, not in a large amounts, however. We had an interest in it because of the ownership of underwriters' warrants under the underwriting. If the company was successful over a period of time those warrants would have been valuable to us. As it turned out they were not valuable, and we never received anything from them at all.

Q. Did you company sell some of these warrants in the latter part of 1939 and during the year 1940?

A. No, we traded in the warrants on a brokerage basis. Each one of the underwriters owned a block of underwriters' warrants, and the other underwriters wanted to register and distribute their warrants. I did not feel that we should recommend to our customers the purchase of the warrants, and we refused to participate in the registration of the warrants and offering them to customers. All of the other underwriters except Lester & Com-

(Testimony of B. P. Lester.)

pany registered their warrants for distribution. We didn't because I didn't feel it was the proper thing to sell them, and we traded them on a brokerage basis entirely, anybody would give us an order.

Q. But the other underwriters, though, registered them [183] and did sell them?

A. I don't think they sold very many of them. My mind is not very clear on just what happened at that time, but they registered them and I think they started to sell the warrants, and then I think there was a changed condition in connection with the company, which I do not recall very clearly, and they withdrew the offer. Now, I don't know how much any one of them sold. I didn't sell any.

Q. I am just wondering if this might refresh your recollection on it, Mr. Lester. I have here an offering of outstanding underwriters' warrants for the purchase of 21,571 shares of Class A common stock, par value \$1.00 per share.

A. That is right.

Q. The units are being offered to the public by the following respective underwriters at \$3.75 per warrant; it mentions then Banks Huntley, O'Brien, Potter & Company, Cohu Brothers, Jorgenson, Hartley Richards, and Air Investors, Incorporated. Is that what you had reference to?

A. That is correct. We didn't register our units, had no intention of distributing to the public.

(Testimony of B. P. Lester.)

Q. I will ask you if that statement I just read is not dated April 26, 1940?

A. Yes, that is printed in the prospectus.

Q. Does that correspond with your recollection of when it was that offering was made? [184]

A. That is my recollection, yes.

Q. I believe those warrants simply entitled the holder to purchase one Class A common share within a certain period of time at \$7.00 per share or 80 per cent of the book value, whichever was higher. Is that right?

A. That is my recollection.

Q. Now, I believe according to the statement you have made your company as brokers did sell certain of these warrants?

A. We traded in the warrants as brokers.

Q. Traded in the warrants? A. Yes.

Q. With whom?

A. With anybody coming and offering them. Not underwriters' warrants, it was the public warrants that we were trading in. At that time there were two groups of warrants. The public subscribed for stock at the rate of five shares of stock and one warrant, that is, as I recall it. And the other class, the underwriters as part compensation for distributing the securities received these underwriters' warrants. The public warrants were registered and were able to be traded in over the counter. The underwriters' warrants were not registered prior to this registration.

Q. Prior to this registration on April 4, 1940?

(Testimony of B. P. Lester.)

A. That is correct. [185]

Q. I don't know, is there any significance to April 4th, indicating they were registered at that time?

A. Well, I would imagine that it was just at that time, because usually the prospectus is dated the date that the registration statement becomes effective.

Q. Now, I notice there O'Brien, Potter & Company. Did Northrop Aircraft have a director by the name of Mr. O'Brien that you know of at any time?

A. Yes, Mr. Roland Lord O'Brien was a director of the company.

Q. Was he a member of this O'Brien, Potter & Company, one of the underwriters?

A. Of Buffalo, New York. That is correct.

Q. Now, I believe you stated that the real basis for your opinion that these restricted shares had no fair market value on March 4, 1940, was because of these restrictions, that is one thing, the second reason being because if these promoters who constituted this, so to speak, unbeatable team, had offered their shares for sale that that would have undermined the confidence of the public in the shares?

A. I think it would have dissipated the confidence of the public in the enterprise.

Q. Well, just because those promoters should sell their shares would not necessarily mean, would it, Mr. Lester, that they would sever their connec-

(Testimony of B. P. Lester.)

tions with the company, [186] their services with the company?

A. I doubt that that would have made any difference.

Q. In other words, they would have stayed with the company just the same?

A. Another thing, in my opinion, the public was told that these particular people with their past experience, who were responsible for the success of the enterprise, would have a very substantial financial stake in the success, and I do not believe that their eliminating that financial stake before they had ever made a company go would have been anything but a bitter blow to the investors in the stock. As an underwriter of that stock I would have recommended to my customers to dump their shares as quickly as they could for anything they might get, and I doubt that they could have, I do not believe they would have received any value for the stock at that time. It was a peculiarly personal promotion, in my opinion.

Q. But each of those promoters under their contract with the company were to receive compensation for the company, weren't they?

A. Yes, very modest compensation, \$9,000.00 a year.

Q. The promoters felt that in receiving this promotion stock they were really receiving a very valuable consideration, isn't that right?

A. Well, I would assume that they would think so, in [187] my opinion.

(Testimony of B. P. Lester.)

Q. In other words, they started out at very modest salaries, didn't they?

A. Yes, in my opinion.

Q. And they left very profitable connections otherwise to give their time over to Northrop, didn't they?

A. I don't think that Mr. Northrop at the time was connected with anybody. He had previously headed up the Northrop division of Douglas Aircraft, but sometime before we put this together he had severed his connection with Douglas. Mr. Cohu had been in the securities business with his brother in New York. I could not tell you how profitable it was. The securities business was not very profitable right before that.

Q. Of course, Mr. Lester, you as an underwriter personally interested in this corporation did not expect that, having only broken ground for their plant on September 19, 1939, and having only completed their plant on February 15, 1940, you did not expect them to show any profits by March 4, 1940, did you?

A. No.

Q. You expected they would go through an initial development period, isn't that right, when most everything would be going out and nothing coming in?

A. That is right. [188]

Q. That is to be expected in any new business, is that right?

A. That is correct.

Q. And particularly a business such as the aircraft business?

A. That is correct.

Q. And particularly the fact that they did not

(Testimony of B. P. Lester.)

show any earnings to March 4, 1940, and the fact that the book value for the outstanding stock was not higher than it was at that time, that is not influencing you in reaching your opinion that this stock had no market value, is it?

A. No, not at all. I was disappointed that they did not get contracts, have contracts on the books before that, but they didn't.

Q. Well, you knew that one of their contracts dated back to December, 1939, didn't you?

A. Yes. That was a pot boiler.

Q. But that was an encouraging sign, was it not?

A. I was disappointed that in that whole fall something more tangible than some parts and some empennages had not been put on the books. I realized that there was an awful lot of work to be done getting the company organized and getting the plant going and all the things that had to be done, but I was somewhat personally disappointed that they did not go better with getting a substantial product. [189]

Q. I believe you stated that, in your opinion, the management of this corporation was excellent?

A. That is my opinion.

Q. I believe it is your opinion that the nature of the business it was in at that time was of the type and character that should cause, with the outbreak of the war, this company to receive very substantial business and assist it towards obtaining a profitable operation.

(Testimony of B. P. Lester.)

A. That was to be certainly hoped for, and I think expected.

Q. And the hopes and the expectations were subsequently justified, were they not, Mr. Lester?

A. They were.

Q. I guess, Mr. Lester, you are a close personal friend of all the petitioners in this case, aren't you?

A. Yes, now I would say I am a close personal friend of all of them.

Q. And you feel very kindly toward them?

A. That is correct.

Q. When did you first have occasion to determine in your own mind what your opinion would be as to the market value of these restricted shares as of March 4, 1940?

A. I'm afraid I don't understand that question.

Q. Did you have any occasion on March 4, 1940, to make a study of the company's circumstances then existing, [190] in order to determine whether or not these restricted shares had any fair market value and what that fair market value was?

A. It never occurred to me at any time until the last few months that it ever had any value at all, for the reasons that I have given.

Q. Did you ever have any occasion to speculate on whether it did have a value or did not have a value?

A. Never did, no.

Q. When did you first notify the Petitioners

(Testimony of B. P. Lester.)

here, Mr. Lester, of the opinion which you have now expressed?

A. I don't think I ever notified them. I think their attorneys called on me, I think first maybe a year ago the auditor of that company, as I recall it, someone connected with the auditing firm of Ernst & Ernst talked to me about the matter, and I think that I expressed myself to him as I have today. About two months ago someone from O'Melveny & Myers' office came around to ask me if I would be willing to testify. I think that was about two months ago. I said I would.

Q. In addition to the facts set out in this stipulation, in reaching your opinion did you make any further or additional independent study of the facts and circumstances?

A. No, I think as far as I know that stipulation contained everything I considered, plus a lot of other things. [191]

Q. You didn't give any weight to this sale by Ellsworth of his contract to Smith in arriving at that conclusion?

A. I considered it, but I doubt whether—I do not think the sale of that interest has anything to do with the principal reason why I felt this stock had no—these interests had no value.

Q. When did you first learn of that Ellsworth transaction, Mr. Lester?

A. About the time that he was talking to him, which I recall was in November, 1939, he came in to see me and said he was hopeful he would be able

(Testimony of B. P. Lester.)

to sell his interest. I believe he needed the money very badly for some personal obligations.

Q. Was it your understanding, Mr. Lester, that Mr. Ellsworth was under a financial strain at that time and was just more or less forced to raise some cash money?

A. No, I don't know that he was forced to. He talked to me about whether or not I thought the common stock was salable, and whether I knew of anybody that would be interested in it, and I didn't.

Q. You didn't have anybody in mind at that time. Now, in reaching this opinion of yours, Mr. Lester, what consideration have you given to the prospective value on March 4, 1940, of these shares of the stock?

A. Well, I—if they did not sell and stayed in with [192] their interests with the company, they had a good prospect, and I gave it consideration in that regard all right, because that was the only basis on which I was interested in the public shares.

Q. In other words, you felt like the success of the company was assured with these men staying in the corporation?

A. I believed there was a better than even chance with them that it would work out.

Q. It does not necessarily follow, does it, Mr. Lester, that Mr. Northrop, Mr. Cohu and these other gentlemen who were interested in organizing this corporation and who did organize it, that if they had sold their shares that they would have sev-

(Testimony of B. P. Lester.)

ered their connections with the corporation and let it go on its own, does it?

A. That would not have made any difference. I think I testified that I believed that there was an absolutely unquestioned moral obligation on the part of these men to stay by that company, and the fact that the public understood that would operate to make a better market on the securities, and if any one of them had violated that obligation to me, I would have turned my back on that company and I would never have had any further business dealings with any of the five of them.

Q. Do you mean you would have taken some personal offense? [193]

A. I would have taken complete personal offense, yes, because I would think that it was an obligation that they were bound by and that they were observing.

Q. You mean you would take such personal offense that you would do anything you could to destroy that corporation?

A. I would do everything I could to save it, and I think the salvation of anybody's interest then would have been to find out where you could put the enterprise into the hands of some other management to have salvaged all the assets that were left.

Q. But you would not have done anything to jeopardize it?

A. I would have done everything to prevent it.

Q. But if one of these gentlemen had sold out

(Testimony of B. P. Lester.)

his shares, you don't mean that you would have gone to your customers and told them to sell all of their shares for anything they could get for them, do you, Mr .Lester?

A. I do, up to the point where there was no orderly market left. From then I think it would have been a matter of calling the stockholders together and attempting to salvage the market.

Q. Now, Mr. Lester, think of the great demand for military aircraft at that time. Now, Mr. Northrop is the head designer and engineer of this corporation, and Mr. Cohu with his experience, Mr. Irving with his experience, don't [194] you think that that corporation would have been a success, that it would have gotten business, regardless of whether these promoters owned any shares in the corporation or not?

A. Yes, I think they might have gotten some business all right, but I think it would have been in a very prejudiced condition in the trade, and right in there we were having trouble enough getting contracts as it was. If we had had to compete with management outside who certainly would have made capital of the fact that they were telling the Government agencies that the principal officers of the company were running off trying to sell their interest, I think we would have had a very hard time getting any work in the enterprise at all. All during the early stages our principal competitors were saying that we could not do the work. We lost one job on that account. If they had been able to

(Testimony of B. P. Lester.)

accompany that with the statement that the principal owners of the corporation did not have enough faith in the enterprise to hold the interest that was given them for the incentive purposes, I think the enterprise would have been so prejudiced in obtaining work that, in my opinion, you would have had only a salvage operation.

Q. A salvage operation at that time, with all this demand for military aircraft, with Mr. Northrop's experience and reputation as an aircraft designer and developer and manufacturer? [195]

A. I think so. I think it would have been as bad for the enterprise as if Mr. Northrop had left, discontinued his services to it.

The Court: We will take a recess.

(Short recess taken.)

The Court: Proceed.

Q. (By Mr. Maiden): Mr. Lester, the company was interested in keeping the services of Mr. Northrop, Mr. Cohu and Mr. Irving, were they not? A. They were.

Q. And it was for that reason, I take it, that in the agreement with those gentlemen, it was stipulated in that agreement that if these men failed to abide by their agreement to stay with the company, that then the company would recapture approximately 60 per cent of their B shares at a price of 25 cents a share, isn't that right?

A. That is my recollection, yes.

Q. Wouldn't you say that that provision gave

(Testimony of B. P. Lester.)

pretty substantial assurance that these men would abide by their agreements with the company and would stay with the company and render the company their services?

A. It should be persuasive.

Q. They, of course, appreciated the value of these shares that they had, didn't they, Mr. Lester, wouldn't you say? [196]

Mr. Wall: I would object to that, your Honor. I don't think Mr. Lester can tell that.

The Court: I don't suppose he can answer that.

Mr. Maiden: No, I guess not, your Honor. He seemed so well informed, though, generally, about the whole thing.

The Court: I think that is a bad precedent anyway.

Mr. Maiden: Yes, I think so.

By Mr. Maiden:

Q. Are you aware, Mr. Lester, that Mr. Cohu in June or July of 1940 transferred a portion of his escrowed shares to members of his family?

A. Yes, I recall that.

Q. Are you likewise aware of the fact that Mr. Northrop in the early part of 1941 likewise transferred in escrow a certain portion of his shares?

A. Well, as I recall it, both these gentlemen made some family arrangements with reference to the stock. I am not familiar with the details but I know that that was being—I understood it was being done.

Q. Isn't it a fact that following the release of a certain portion of these A shares from escrow in

(Testimony of B. P. Lester.)

1940, that some of these gentlemen sold some of these Class A shares issued to them at that time?

A. I think Mr. Cohu along in the end of 1940 sold some [197] shares. I mean, I was not informed that anyone else had.

Q. Did the fact that Mr. Cohu and Mr. Northrop made transfers in escrow of their restricted shares, did that shake your faith in the company or cause you to believe that the company should be liquidated?

A. Not in view of the fact that they were to members of their immediately families.

Q. Suppose those gentlemen had sold, on March 4, 1940, these shares that they received from the company; would that necessarily have been public property so as to have shaken the faith of the public in this company?

A. Well, you are required as an underwriter of the stock in handling sale of those shares for 13 months to furnish a copy of a prospectus. Those prospectuses that we use in connection with the offer of securities are required to be kept alive for 13 months, and we would have been compelled to make that public and give that public knowledge, because we should have amended the prospectus and would have done so in connection with those sales.

Q. But in doing that you would have referred to the fact that you had firm contracts with those gentlemen that they would stay with the corporation and that they would render their services to the corporation, and that if they did not stay with the corporation that the company could recapture from

(Testimony of B. P. Lester.)

them a great portion, about 60 per cent of their Class B [198] shares, isn't that correct?

A. Well, you would not have changed the material in the prospectus in any other respect than to show the fact that they sold, but my point is, had they sold it would not have mattered what was in the prospectus, you would not have had a purchaser.

Q. Do you mean to tell me that it is your opinion that there would not have been any buyers at any price for those shares in this war industry, on March 4, 1940? A. Well, you might have had——

Q. I mean, I want to be perfectly fair about it.

A. I think you might have had an occasional sale, very largely, in my opinion, to uninformed people. The fact that, for instance, there was a market for this stock, as I recall it, in May or in April which ran as high as about \$8.00 a share—now, to the best of my recollection I don't think we ever had a transaction in which we sold stock at that time higher than \$8.00 a share, that was about the then current market. At that same time, the right to subscribe for stock at \$7.00 a share, which is what these warrants provided, was selling about \$3.00 or \$3.50 in limited amounts. Now, there is a certain amount of fringe gambling in the thing anyway, and I certainly would not say that there would not be some sales of stock, but a regular market for the securities, and I am talking of a market which would—[199] where it would be more than just a few uninformed speculators, I think would have vanished, because of the peculiar relationship of these people

(Testimony of B. P. Lester.)

to this enterprise until it got over the hump. Now, when it gets over the hump, that is again a matter that people can differ on, when it is established——

Q. Mr. Lester, it is not necessary, is it, for the management of the company to be the stockholders of the company?

A. No, in most instances, at least certainly in many instances that is not a necessary thing at all. A great many companies are not.

Q. Again, can an official of the company be deeply interested in the company and give his all to that company, even though he does not own any stock in the company.

A. That very frequently happens, I think.

Q. Wouldn't you have expected Mr. Northrop to have remained with this corporation and to have given his full services, and just as much so, even if he didn't own any shares?

A. Well, sir, I think I testified that if Mr. Northrop had sold his shares I would have taken it and I think the public would and I believe every other underwriter would, as a complete repudiation of an understanding and a moral obligation not to liquidate his interest that way.

Q. Now, there is one other little thing I want to get [200] straightened out, Mr. Lester, about these warrants. Suppose I purchased a warrant and paid \$3.00 for it, then when I went to buy one of those Class A shares with it, we will say that \$7.00 was the highest value, was greater than 80 per cent of the book value, then I would have to pay the company \$7.00 for the share, so that the share actually would

(Testimony of B. P. Lester.)

have cost me \$10.00? A. That is correct.

Mr. Maiden: I believe that is all, your Honor.

The Court: Any redirect?

Mr. Wall: Yes, if your Honor please.

Redirect Examination

By Mr. Wall:

Q. Mr. Lester, during your cross-examination you testified, I believe, that you assumed that the promoters involved considered this stock to have substantial value. Did you mean that statement to alter in any way your testimony as to your opinion concerning its fair market value on March 4, 1940?

A. Not at all.

Q. A moment ago you made a statement that the market on these shares in May was at one time as high as \$8.00. Were you referring there to the public shares issued to the public?

A. I was referring to the unrestricted Class A shares. [201]

Q. Not to the shares issued to the promoters?

A. Not at all.

Q. In your opinion, Mr. Lester, does the fact that some warrants were sold at a price, let us say \$3.00, which, as Mr. Maiden has pointed out, would mean if the holder of that warrant purchased the stock at \$7.00 the ultimate cost of the stock to him was \$10.00, does the fact that some warrants were sold on that basis, in your opinion, indicate any fair market value for the promotional shares here under consideration? A. Not in my opinion.

Q. Can you give your reasons for that, Mr. Lester?

(Testimony of B. P. Lester.)

A. Well, the market for warrants to subscribe to stock in the company is, you might say, a call on stock at a price. Now, strange as it may seem, whenever there are warrants outstanding, in most instances they sell at a premium above the then market price of the shares plus the amount of the warrant. In other words, it is not unusual for a warrant that calls for delivery of stock any time up to five years at \$7.00 to sell at \$3.00 while the stock itself then is only selling at \$7.00 or \$8.00, because there seems to be a segment of the public that in a limited sort of a way likes to speculate in just that type of thing, when he does not put up all his money or have to put up the larger part of it for a long period of time. It is a call. And that, I think, [202] has been the history of most securities of that kind. There have been a great many companies that have issued warrants, calls on stock in the future, in the hopes that they will be exercised and some additional capital raised that way.

Q. Would a purchaser of one of those warrants be able to turn around and sell it on the market within a reasonable length of time?

A. Well, there was a market, I think, during this whole period that has been discussed here, for warrants, a limited market. There were not many warrants traded, but they traded in a very fairly constant range all the time.

Q. Mr. Lester, were these warrants deliverable negotiable securities, in the language of the securities business?

A. Yes, they were in form for good delivery.

(Testimony of B. P. Lester.)

Q. Mr. Lester, you have testified on cross-examination something concerning the purchase of the 30,000 shares by the Atlas Corporation. Did the Atlas Corporation approach you or approach the group of underwriters in an effort to buy those shares?

A. No. We started out offering the shares of Northrop, and very frankly, they were not well received at all. After, I think, about ten days or two weeks of trading, there was a very, very small amount of stock sold, or subscribed for.

Q. What time are you talking about now? [203]

A. I am talking about June 21, 1939.

Q. It is in evidence that the offering began, I think, July 21, 1939. Does that refresh your recollection, the offering of the underwriters to the public?

A. The offering by the underwriters to the public, the first offering of shares to the public. That went so badly that we held several underwriters' meetings with the promoters, and we felt that the hope for successful distribution of the stock to raise the capital that was required rested on our being able to obtain some group or investment company that had the reputation of being an initiated investor to take a very substantial interest in the stock of the company. At one of those meetings we discussed a list of people, among them the Atlas Corporation. I had been acquainted since 1920 with Mr. Floyd B. Odium, who is president of the company, and Mr. Northrop had been acquainted with Mr. Odium and with Mrs. Odium, who was a flyer, for some years past.

Q. Mr. Odium was Jacqueline Cochran, was she not?

(Testimony of B. P. Lester.)

A. That is correct. I phoned Mr. Odlum the next morning and asked him if he would entertain such a thought. He said he would if we could come to New York and discuss it with him, and that noon Mr. Northrop and I flew to New York and talked with Mr. Odlum the following evening. The outcome of these conversations was that about ten days or two weeks later the Atlas Corporation made a subscription. [204]

Q. Those are the circumstances, then, under which Atlas was interested in the proposition?

A. That is correct. I might say that accomplished what we believed it would, in that it gave approval to the promotion from an informed investor.

Mr. Wall: That is all.

Recross-Examination

By Mr. Maiden:

Q. I notice a statement in the prospectus, which is Exhibit 1-A to the stipulation, Mr. Lester, to the effect that "Each of the underwriters has advised the company that it has no unsold unwritten or agency units as of March 26, 1940, except that Lester & Company advised the company that at said date it owned in addition to underwriters' warrants 1,430 shares of Class A common stock and 337 public warrants, and Air Investors, Incorporated, advised the company that it owned 600 units which were being retained by it as an investment." You understand that to be the fact? A. Yes, I do.

Mr. Maiden: I believe that is all, if your Honor please.

The Court: That is all, Mr. Lester.

(Witness excused.)

The Court: Call your next witness. [205]

Mr. Wall: I will call Mr. Henry Bateman, if your Honor please.

Whereupon,

HENRY M. BATEMAN

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Henry M. Bateman, 555 Muirfield Road, Los Angeles, California.

Direct Examination

By Mr. Wall:

Q. What is your business or occupation, Mr. Bateman? A. I am an investment dealer.

Q. Are you associated with the firm of Bateman, Eichler & Company of this city? A. I am.

Q. And are you an officer of that firm?

A. I am president of that firm.

Q. How long have you been engaged in the securities business, Mr. Bateman? A. 27 years.

Q. Was your firm of Bateman, Eichler & Company one of the underwriters on the Class A common stock of the Northrop Aircraft, Inc., to be offered to the public in 1939? [206] A. It was not.

Q. Was your firm ever approached with a proposal that you become a member of that group of underwriters? A. It was.

(Testimony of Henry M. Bateman.)

Q. What was the action of your firm on that proposal?

A. We declined to become a member of the underwriting group.

Q. Do your activities in the investment business, Mr. Bateman, involve the determination of the value of securities of various types? A. Yes.

Q. Does that include stocks as well as bonds?

A. Yes.

Q. Has your experience in that connection included aircraft securities? A. Yes.

Q. And securities of new enterprises?

A. Yes.

Q. In what way do your activities involve the valuation of securities, Mr. Bateman?

A. I am in charge of the underwriting activities of our firm. I also serve a number of personal clients, I give advise to a number of personal clients.

Q. And for the purpose of determining whether or not you will underwrite a particular issue, it becomes necessary [207] for you to determine values of securities, does it?

A. That is the first thing you have to do when you start buying a security.

Q. And the same is true, I assume, in advising those clients that you mention? A. Yes.

Q. Would you please enumerate briefly the elements of valuation that you customarily consider important in valuing a common stock?

A. I would say that the first thing we consider is the nature of the company's business, whether or not it is a stable business, whether it is a business

(Testimony of Henry M. Bateman.)

that is continuing, that is, where the company's products are products that are in demand over long periods of time, not specialized products.

I would say the second thing that we give consideration to is management. I believe thereafter we would consider as of next most importance the future prospects of the company as to future business. We then give consideration to the financial condition of the company, whether or not it has insufficient capital to engage in business, whether it has plant facilities. There are a number of other things that ultimately come into consideration, but those are the most important.

Q. Now, Mr. Bateman have you made a study of the facts in this case as set forth in the stipulation which has been filed in the matter? [208]

A. I have.

Q. Did your study include the Articles of Incorporation of Northrop Aircraft, Inc., and particularly the provisions of Article 5 with respect to Class B shares of that company? A. Yes.

Q. Did your study include the contracts between the company and the respective promoters dated June 17, 1939? A. Yes.

Q. Did your study include the terms of the Corporation Commissioner's Permit of June 15, 1939?

A. Yes.

Q. And particularly the conditions specified in that permit as being applicable to the shares issued to the promoters? A. Yes.

Q. Are you familiar with the agreement between the company and the respective promoters dated as

(Testimony of Henry M. Bateman.)

of November 30, 1939, whereby the promoters waive their rights to participate in dividends and in distribution of assets in accordance with the Corporation Commissioners' Permit? A. I am.

Q. Were you present in the court room during the testimony of Mr. Claude M. Monson with respect to the business condition and prospects of Northrop Aircraft, Inc., on or about [209] March 4, 1940?

A. I was.

Q. Have you reviewed the balance sheet of the company as of February 29, 1940?

A. I have.

Q. Are you familiar with the information set forth in the stipulation in Paragraphs 40 to 43, concerning orders on file with the company on March 4, 1940, the fact that it then made no sales deliveries, the fact that it then had 142 employees, and the fact that it only shortly before that time had completed the erection of the factory at Hawthorne, California?

A. Yes.

Q. Are you familiar with the information set forth in Exhibit 19-U to the stipulation regarding the number of unrestricted public Class A common shares purchased and sold by Lester & Company during the period from November 9, 1939, to March 8, 1940, and the price at which those shares were purchased and sold?

A. Yes, in a general way.

Q. Now, Mr. Bateman, for the purpose of answering the question I am about to put to you, I will give you the following definition of the term fair market value. By the term fair market value is meant

(Testimony of Henry M. Bateman.)

the fair value of property in money as between one who wishes to purchase and one who wishes [210] sell, that is, the price at which a seller wishing to sell at a fair price and a buyer willing to buy at a fair price will trade, neither being under any compulsion to trade, and both having a reasonable knowledge of the facts. I caution you that the prices at which stock was sold on an over-the-counter market or stock exchange are not necessarily controlling in fixing the fair market value of that stock, although such prices are a factor to be considered along with other factors of valuation. I also caution you that sales made under peculiar and unusual circumstances, such as sales of small lots and sales in a restricted market are not necessarily controlling in fixing fair market value. In formulating your opinion and in answering the question I am about to put to you, Mr. Bateman, I will ask you to put yourself back at March 4, 1940, disregarding all facts occurring after that date, and limit yourself to the facts which were known on or before that date or could then have been reasonably anticipated. What, in your opinion, Mr. Bateman, was the fair market value on March 4, 1940, of the Class A common shares of Northrop Aircraft, Inc., which were issued to Messrs. Northrop, Cohn, Irving, Bellande and Stephens as promoters of that corporation?

A. In my opinion, those shares had no market value.

Q. What, in your opinion, was the value on March 4, 1940, of the Class B common shares of Northrop

(Testimony of Henry M. Bateman.)

Aircraft, Inc., [211] which were issued to those gentlemen as promoters?

A. In my opinion, they had no market value.

Q. Will you please state the reasons on which you base the opinion you have just expressed, Mr. Bateman?

A. Yes. To start with the Corporation Commissioner when he permitted the Northrop Aircraft Company to sell the public shares imposed a condition first, that the company enter into an agreement with Northrop and the other gentlemen under which they agreed to waive all distributions to stockholders of the company to which they might be entitled as the owner of the restricted A shares, during such period that the shares were to be held and held in escrow; that further, the agreement further provided that they would waive all dividends which the company might declare on shares of the company to which they might be entitled during the period that their shares were held in escrow. The Corporation Commissioner further provided that all of the promoter's shares issued to them must be held in escrow until such time as he might permit their withdrawal. We know—I know from the stipulated facts that the escrow agent had been appointed by a separate appointment, and as of March 4, 1940, the shares were issued and placed in escrow with the Bank of America as the escrow agent. I further know that the Corporation Commissioner at that time, and I think this is still his rule, and I believe—— [212]

Mr. Maiden: If your Honor please, I object to this witness testifying as to what the Corporation

(Testimony of Henry M. Bateman.)

Commissioner's rules and regulations are. That is a matter of law, and as to what the Corporation Commissioner would do at any time is certainly solely within the knowledge of the Corporation Commissioner, upon the basis of the facts presented to the Corporation Commissioner at any particular time.

The Court: You anticipate he is starting to tell that.

Mr. Maiden: That is what I think he is, yes, sir.

The Court: Well, you better not state what the Commissioner would do.

The Witness: May I say that I believe it is the stipulation in this case?

Mr. Wall: There are attached to the stipulation certain rules of the Corporation Commissioner, Mr. Bateman. Though it would not be proper for you to testify as to what the Commissioner would do in any particular case, I think Mr. Bateman, however, can take into consideration the rules which are attached to the stipulation in making his statement.

The Court: Yes, he may do that.

By Mr. Wall:

Q. Would you like to see those rules, Mr. Bateman?

A. I would, please.

Q. That is Exhibit 10-J to the stipulation which I am [213] now showing the witness.

A. Ordinarily shares issued as promotion shares may be considered for release from escrow when the holders of shares sold under a permit have received a return in the form of dividends equal to the sale price, or when the net tangible assets of the company approximate the aggregate par value or stated value

(Testimony of Henry M. Bateman.)

of the non-par shares outstanding, or when a successful earning record is shown for three successive years.

Q. What were you reading then, Mr. Bateman, what section?

Mr. Maiden: You did not complete reading that, did you, Mr. Bateman? Isn't there a further statement there, that the action of the Commissioner will be based upon the facts and circumstances of each particular case?

The Witness: Yes.

By Mr. Wall:

Q. That was reading from Section 7 of Chapter 9 of the regulations of the Commissioner attached to the stipulation which is in evidence.

A. On March 4, 1940, the stockholders of Northrop Aircraft had received no distributions. On March 4, 1940, no dividends had been declared, on the capital stock of the company. On March 4, 1940, the net current assets per share of the company, including the shares of promotion stock, did [214] not equal the price named in the permit of the Commissioner of Corporations, and on March 4, 1940, the company had no earning record to show to the Corporation Commissioner. Therefore, on March 4, 1940, a prospective purchaser of any of those restricted shares would have first, he would have had to get the permission of the Corporation Commissioner to transfer the shares; he could not have anticipated when those shares might have been withdrawn from escrow; he could not have anticipated when the company might have shown earnings, when the company might have built up sufficient assets to make the net

(Testimony of Henry M. Bateman.)

tangible assets per share equal to the permit price; he could not at that time anticipate, in my opinion, the growth possibilities of the company. Therefore, any prospective purchaser or any individual to whom those—I will phrase that differently. Therefore, in my opinion, that stock on that date, by very reason of the conditions imposed by the Corporation Commissioner, were not marketable securities and therefore had no firm market value as of that date.

Q. Does your statement, Mr. Bateman, apply to both the Class A and Class B shares that were placed in escrow?

A. If it applies to the Class A it must apply to the Class B. It applies to both classes of stock.

Q. Did you give consideration in reaching your opinion, Mr. Bateman, to the restrictions of the Articles of [215] Incorporation relating to the Class B shares alone which did not relate to the Class A shares? A. Yes.

Q. What weight did you give to those restrictions, if any?

A. In my opinion, the main things that caused me to believe that the stock had no fair market value at that time were the facts that I have brought out, with reference to the fact that they were so restricted that the purchaser could not anticipate when he might get his securities, and because of the conditions he could not anticipate at that time whether or not he would ever receive them, inasmuch as the agreement with Mr. Northrop and the others provided that while those shares were held in escrow they waived all distributions and all dividends; a condition might

(Testimony of Henry M. Bateman.)

arise whereby the company would never have made earnings, the company conceivably might have gone bankrupt, and an informed buyer must have taken into consideration the fact that all he was buying was a call on stock if the company was successful. Actually that is all, in my opinion, that Messrs. Northrop and the others had.

Q. Did you take into consideration, Mr. Bateman, the fact that the company at that time had no product ready for sale, and the fact that it had only a few orders on its books?

A. Naturally that had to be taken into consideration. Had the company had on its books the contracts that it had a [216] year later, it would have made an entirely—presented an entirely different picture.

Mr. Maiden: They would have a fair market value had that been true, is that right?

Mr. Wall: Just a moment, Mr. Maiden. Would you mind waiting for your cross-examination until I have finished the direct?

Mr. Maiden: Would you mind letting him answer that question?

Mr. Wall: No, he can answer that.

The Witness: What was the question?

Mr. Maiden: Mr. Reporter, would you read it?

(The question was read.)

The Witness: The amount of orders that they had on their books would have had to have been taken into consideration in determining a market value, but by the time of 1940, you would also—by the end of 1940 you would have had to have taken into con-

(Testimony of Henry M. Bateman.)

sideration, you would have had to take into consideration what the company had earned in the past. There are a lot of things that go to the making up of market value. Now, we are concerned here, it seems to me, with something that is different from the market value on the unrestricted shares. We are here considering restricted shares and when we do, in my opinion, all of the prospects of the company and the orders on the books of the company have a [217] bearing in this case as to whether or not we could lead an informed buyer to believe that he might have a prospect of getting delivery of the securities, for the securities might have become void through the company going out of business and distributing what assets it had to the public stockholders, leaving the A stock and the B stock of these men worthless.

Q. In arriving at that opinion, Mr. Bateman, did you give consideration to the status of the European war as of March 4, 1940?

A. Well, that had, that would have had a considerable bearing at the time, and I gave it consideration. As I remember the European war, in March of 1940 a lot of people were very confused as to what was happening, whether we had an actual war that was going to become a world war. We know that all nations, all of the democratic nations were arming in anticipation that the worst might happen, but insofar as the public was concerned, we didn't know, I didn't know what was going on. I could not understand, with war having been declared in March, that something was not happening more than had

(Testimony of Henry M. Bateman.)

happened. War had been declared—did I say March?

Q. You said March.

A. I mean September of 1939.

Q. September of 1939? A. Of 1939. [218]

Q. In arriving at your opinions, Mr. Bateman, did you give consideration to the size of the stock holdings involved of these various promoters in relation to the indication of the number of shares being sold at that time by Lester & Company and purchased by Lester & Company?

A. Very little, very little. Had I been approached to handle a thousand of those shares, I would have said no just as quickly as for 50,000.

Q. In arriving at your opinion that you have expressed, Mr. Bateman, did you give consideration to the provisions of the agreement between the company and the respective promoters, which in the case of Messrs. Northrop and Cohu and Irving did give the company an option to buy 60 per cent of their Class B shares at 25 cents a share under certain conditions?

A. I gave some consideration to it, but again I say that I didn't think that that was an important factor in my arriving at the opinion that the stock had no market value.

Q. In other words, as I understand you, your opinion applies on Class A and Class B shares alike, without regard to the specific restrictions on the Class B shares? A. That is right.

Q. Did you give consideration to the transaction whereby Mr. Ellsworth in November of 1939 exchanged his contract with the Northrop Company for

(Testimony of Henry M. Bateman.)

2,200 shares of Duvall Texas Sulphur Company stock? [219] A. Yes.

Q. What weight, if any, did you give that transaction?

A. Well, I gave practically no weight to that transaction. A clever salesman can negotiate the sale of almost any article or any security. That has been done in connection with gold bricks. That, in my opinion, the price at which an article or security is negotiated over a long period of time with some buyer, whether or not he is informed, does not necessarily establish a market value of an article or security in question.

Mr. Wall: That is all.

Cross-Examination

By Mr. Maiden:

Q. There is no evidence in this record, is there, Mr. Bateman, that you have seen or that you have heard that would indicate that Ellsworth's sale to Mr. Smith was handled by a slick salesman?

A. I didn't say a slick salesman.

Q. A slick broker? A. No, sir.

Q. What did you say in that respect?

A. Let the reporter read it.

Q. Just go on and tell me what.

A. I said that a clever salesman—he asked what weight I gave to that transaction, and I said none, practically [220] none, because I said a clever salesman can negotiate the sale of any article or security, I believe.

Q. I beg your pardon. Is there any evidence in this record that you know of, either in the stipula-

(Testimony of Henry M. Bateman.)

tion or what you have heard testified to, that Mr. Smith was not a well informed purchaser at the time he made that purchase of Mr. Ellsworth?

A. I believe that Mr. Smith was a very well informed purchaser.

Q. Would not that influence you in determining whether or not several months later stock, when it had actually been issued, had a fair market value, if at an antecedent date simply a contract right sold for a valuable money consideration? A. No, sir.

Q. I believe the sense of your opinion is that this stock, in your opinion, had no fair market value because in your opinion it was not marketable at that time, is that right? That is really the sense of your entirely testimony, isn't it, Mr. Bateman?

A. No, not at all. My opinion that the stock had no fair market value at that time is based largely on the fact that on March 4, 1940, no prospective purchaser of that stock could have any real reason for believing or knowing that the company was going to be successful, and—— [221]

Q. Mr. Bateman, just one second, please. Do you mean to tell me that on March 4, 1940, following the outbreak of the war in Europe on September 1, 1939, despite our national defense program in this country, despite the feverish effort of a number of European democracies to arm themselves sufficiently to withstand Hitler's assault which they anticipated in the spring of 1940, do you mean to say that on March 4, 1940, a company engaged, set up for the purpose of manufacturing one of the most important tools of modern warfare, a military air-

(Testimony of Henry M. Bateman.)

craft, and built around men of such outstanding ability and reputation as this company had, do you mean to say that on March 4, 1940, taking into consideration all those things, that there was no reasonable basis for any informed person believing that this company had a great future in the aircraft industry and had a great opportunity to develop itself and to operate profitably?

A. Well, I can say to you that if anything had been done between September 1, 1939, and the date that Hitler invaded the Low Countries to patch up the differences, to have some kind of a peace, that the armament program of the United States as well as the European countries would have slowed down to a walk and we have heard Mr. Lester testify to the fact that this country in the spring of 1940 already had spent too much money and was then in straitened circumstances. [222]

Q. But in the event of a peace, as you say, it would have just been an armed truce, wouldn't it, Mr. Bateman?

A. Well, you are asking a little too much of me. I am just a security dealer.

Q. Do you have knowledge of the fact that on March 4, 1940, the relations of the United States and Japan were in a very critical condition?

A. I have been in California for a great many years, and relations between California and Japan have been strained from time to time.

Q. And the United States, in fact?

A. I knew on December 7, 1941, that the rela-

(Testimony of Henry M. Bateman.)

tions with Japan were very strained, but up to that time I knew what I read in the newspapers.

Q. Mr. Bateman, just fairly now and frankly, I am going to move you back to March 4, 1940, and you are in the investment business. Wouldn't you and didn't you consider at that time that investments in American companies that were engaged in the production of war tools and material offered very bright prospects for an investment standpoint, taking into consideration the conditions brought on the world by the war in Europe?

A. Sir, that question would be just about the same as if an investor would come in to me tomorrow and ask whether to buy a stock or not to buy, and not name the specific stock. [223] Here was a company, the Northrop Aircraft Company, that was a promotion pure and simple. The promoters of this company put not one red nickel into this company. The public put up all of the money.

Q. That is not unusual, is it, Mr. Bateman?

A. Very unusual, very unusual.

Q. But it was done?

A. The situation was such that when I was invited, and I sat in, they called me down to a meeting and I heard the story, and I declined to become an underwriter. I also declined to sell any stock for the selling group. My organization handled no stock of that company. Later on we may have executed an agency order for the stock, but we sold no stock to our customers. We considered the stock too speculative to sell to our clients.

(Testimony of Henry M. Bateman.)

Q. Well then, if all the underwriters had been of the same opinion that you were, then it is obvious that this company never would have been organized, isn't that right?

A. That is exactly right.

Q. You could not see on March 4, 1940, that there would be any profits in an industry engaged in the manufacture of war equipment, is that right, Mr. Bateman?

A. I could see that there were tremendous profits to be made by certain companies. This company had had to start in the business with great competition, and there was great [224] competition.

Q. What study had you made then of the demand conditions for that product and of the existing industry's ability to meet that demand at that time? What study had you made of that, Mr. Bateman?

A. I have not made a detailed study of that, but I can call attention to evidence that has been presented in this case. It was not until 1941 that aircraft companies began to operate on a cost-plus basis. In 1940 they were all out fighting for business and bidding fixed prices to get business and they don't do that if the demand is greater than their capacity.

Q. In other words, it is your opinion, is it, that on March 4, 1940, there was no more than the usual demand for military aircraft, is that right?

A. There was great demand, the demand was growing all the time. I think the demand for mili-

(Testimony of Henry M. Bateman.)

tary aircraft, if I had to give you the time, my opinion is that it would be about 1937.

Q. When the demand started for military aircraft? A. Yes.

Q. But that demand was greatly accelerated, all out of natural proportion, wouldn't you say, by the critical developments in Europe and the outbreak of war on September 1, 1939?

A. Yes, but in my opinion all of the leading aircraft [225] companies that were in business had increased their facilities during that time to take care of greater business.

Q. I understood you to say that you had not made any investigation or study to determine to what extent the existing industry was capable of meeting that demand.

A. You can't engage in the security business without being informed about all kinds of business. I said I had made no detailed study.

Q. All right. Now I want to find out just to what extent you did make your study, and I want you to tell me approximately the amount of business that leading aircraft companies in the United States had as of March 4, 1940, and I want you to tell me their then-existing physical capacity to take care of those orders.

A. I can't give you those figures.

Q. Mr. Bateman, were you ever called on to try to sell any of these promotional shares?

A. By the Northrop Aircraft Company?

Q. Yes.

(Testimony of Henry M. Bateman.)

A. I have already testified that we were invited.

Q. You are aware of the fact that the Corporation Commissioner's regulation provide for the sale and transfer of shares in escrow, aren't you?

A. That is right, yes.

Mr. Maiden: I believe that is all, your Honor.

Mr. Wall: No further questions.

The Court: That is all, Mr. Bateman.

(Witness excused.)

The Court: We will adjourn until 10:00 o'clock tomorrow morning.

(Thereupon, at 4:45 p.m., an adjournment was taken until the following day, Wednesday, November 13, 1946, at 10 o'clock a.m.) [227]

November 13, 1946—10:00 a.m.

The Court: We will proceed now with the hearing in the Cohu and other cases.

Mr. Wall: Very well, your Honor. I will call Mr. Justus A. Hahn, your Honor.

Whereupon,

JUSTUS A. HAHN

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name and address, please.

The Witness: Justus A. Hahn, 845 South Plymouth Boulevard.

(Testimony of Justus A. Hahn.)

Direct Examination

By Mr. Wall:

Q. What is your business or occupation, Mr. Hahn?

A. Assistant Commissioner of Corporations, State of California.

Q. Are you in charge of the Los Angeles office of the Commissioner of Corporations?

A. Yes, that is right.

Q. How long have you held that office as Assistant Commissioner? A. A good many years.

Q. Did you hold that position in 1939? [231]

A. Yes.

Q. Is it customary, Mr. Hahn, for the office of the California Corporation Commissioner to require promotional securities to be held in escrow for a period? A. Yes, it is.

Q. Are you familiar with the general practice of the Corporation Commissioner's office as it existed in 1939 with respect to the approval of escrow holders of corporate securities which are required to be appointed under the terms of permits issued by the Commissioner? A. Yes.

Q. What was the general practice in 1939 in the Corporation Commissioner's office, Mr. Hahn, with respect to approving as an escrow holder for securities under such a permit a national banking association with trust powers doing business in California, such as the Bank of America National Trust and Savings Association, or the Security-First National Bank of Los Angeles?

(Testimony of Justus A. Hahn.)

A. They would be proper as such escrow holders.

Q. Would the same apply, Mr. Hahn, to a bank like the Farmers & Merchants National Bank of Los Angeles? A. Yes.

Q. The Citizens National Trust & Savings Bank?

A. Yes.

Q. The California Bank? [232] A. Yes.

Q. Union Bank and Trust Company?

A. Yes.

Mr. Wall: That is all, your Honor.

Mr. Maiden: No questions.

The Court: That is all.

(Witness excused.)

[Endorsed]: T.C.U.S. Filed Dec. 4, 1946. [233]

In the United States Circuit Court of Appeals
for the Ninth Circuit

T. C. Docket No. 5041

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW

Now comes John K. Northrop, petitioner in this cause, by his attorneys, Maynard J. Toll, Sidney H. Wall and George F. Elmendorf, and petitions for a review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of The

Tax Court of the United States rendered on June 18, 1947, determining a deficiency in petitioner's federal income tax for the calendar year 1940 in the amount of \$57,474.19. In support of his petition, petitioner respectfully shows:

1. VENUE

Petitioner on review (hereinafter sometimes called "petitioner") is a resident of the County of Los Angeles, State of California. Petitioner's return of federal income tax for the calendar year 1940, in respect of which the asserted liability arises, was filed with [234] the Collector of Internal Revenue for the Sixth District of California, whose office is located in Los Angeles, California, within the jurisdiction of the Circuit Court of Appeals for the Ninth Circuit.

2. NATURE OF CONTROVERSY

The controversy relates to the proper determination of the petitioner's liability for federal income taxes for the calendar year 1940. The basic questions are (a) whether or not certain stock received by petitioner constituted a realization of income by petitioner (to the extent of petitioner's community one-half thereof) in 1940, and (b) if so, what was the amount thereof.

Petitioner, an aeronautical engineer and aircraft designer, was one of the promoters of Northrop Aircraft, Inc. (herein called the "Company"), a California corporation organized in March, 1939, to engage in the business of designing and manufacturing aircraft and aircraft parts. The Company was

authorized to issue two classes of stock, known as Class A Common and Class B Common.

On June 17, 1939, a contract was entered into between petitioner and the Company by which the Company agreed, in consideration for the use of petitioner's name, his past promotional services and his agreement to be employed by the Company to take charge of engineering and design for five years, to issue to petitioner certain of [235] its Class A and Class B shares on the basis of a specified ratio to the number of its Class A shares which should thereafter be sold to the public.

Pursuant to a permit issued by the California Corporation Commissioner on June 15, 1939, the Company, from July 21, 1939, to November 28, 1939, sold and issued 250,000 of its Class A shares to underwriters for distribution to the public, receiving \$5 per share therefor. The sale of the 250,000 Class A shares by November 28, 1939, entitled petitioner, under his contract with the Company, to 15,384 Class A shares and 38,461 Class B shares.

The Corporation Commissioner's permit required that all the shares to be issued to petitioner pursuant to his contract should be held in escrow until released by the Commissioner, prohibited sale of any such escrowed shares without the Commissioner's consent, and required certain waivers of petitioner's rights to receive dividends and to participate in distributions of assets while the shares were held in escrow.

The Company, in June, 1939, designated the escrow holder pursuant to said permit. The Corpora-

tion Commissioner's approval of said escrow holder was sought and obtained, and the required waiver of petitioner's rights with respect to dividends and assets was executed and filed, in January, 1940. The certificates representing the Class A and Class B shares in question were issued in [236] petitioner's name on March 4, 1940, and were forthwith placed in escrow pursuant to the conditions of the permit. They remained in escrow subject to such conditions until October 26, 1942, except that on November 19, 1940, one-third (or 5240) of petitioner's Class A shares were released by order of the Corporation Commissioner.

In addition to the restrictions contained in the Corporation Commissioner's permit, the Class B shares issued to petitioner were, under the Company's articles of incorporation, restricted as to receipt of dividends and as to distribution of assets on liquidation, and were to become void on August 1, 1944, if no adjusted net profits were theretofore earned by the Company; they were to become convertible into Class A shares on or before August 1, 1944, only if specified earnings requirements per Class A share had been met.

Furthermore, 60% of the Class B shares issued to petitioner were, under his contract with the Company, subject to an option in the Company to repurchase at 25 cents per share in certain events.

The Commissioner of Internal Revenue determined that the Class A and Class B shares issued to petitioner were received by him on March 4, 1940, when the certificates representing such shares

were issued and placed in escrow, and that they constituted income in that year, to the extent of his community one-half thereof, in the amount [237] of their fair market value. The Commissioner determined that value to be \$6.25 per share for both Class A and Class B shares, a figure approximating the then current over-the-counter price for publicly held Class A shares which were subject to no restrictions or options. Petitioner contended (a) that the shares were received in 1939 when his right to them accrued, and not in 1940 when the certificates representing the shares were issued, and (b) that even if the shares were received in 1940, they had no fair market value at the time of such receipt.

3. PRIOR PROCEEDINGS

On the basis of his determination as aforesaid, the Commissioner of Internal Revenue, on or about February 24, 1944, notified petitioner of a deficiency in his Federal income tax for the calendar year 1940 in the amount of \$99,479.05. Petitioner filed in the Tax Court of the United States his petition for a redetermination of such asserted deficiency; and an answer was filed in due course by the Commissioner of Internal Revenue. The case was tried before a Division of the Tax Court in Los Angeles on November 12 and 13, 1946, after having been consolidated for purposes of hearing and briefing with the case of petitioner's wife, Inez H. Northrop v. Commissioner of Internal Revenue, Tax Court Docket No. 5042, and with the cases of other promoters of Northrop Aircraft, Inc. [238] (and their respective

wives) who had received shares of its stock under similar circumstances.

The Division of the Tax Court held that the shares received by petitioner constituted a realization of income by him in 1940, and that both the Class A and Class B shares so received then had a fair market value of \$4.00 per share. Petitioner moved for a review by the full Tax Court of the findings of fact and opinion of the Division of the Tax Court embodying such holding. Such motion was denied, and on June 18, 1947, a decision was entered to the effect that there was a deficiency in petitioner's income tax for the calendar year 1940 in the amount of \$57,474.19.

4.

The petitioner is aggrieved by the findings of fact and conclusions of law in the findings and opinion of the Tax Court and by its decision entered pursuant thereto, both with respect to the decision that the shares were received by petitioner in 1940 rather than in 1939, and with respect to the decision that both the Class A and Class B shares had a fair market value of \$4.00 per [239] share, or any fair market value, when the certificates therefor were issued in 1940.

MAYNARD J. TOLL,
SIDNEY H. WALL and
GEORGE F. ELMENDORF,

By SIDNEY H. WALL,
Attorneys for Petitioner.

[Endorsed]: T.C.U.S. Filed Sept. 15, 1947 [240]

[Title U. S. Court of Appeals and Cause No. 6041]

NOTICE OF FILING PETITION FOR
REVIEW

To Commissioner of Internal Revenue and Charles
Oliphant, Chief Counsel, Bureau of Internal
Revenue, Washington, D. C.

You Are Hereby Notified that the petitioner on
the 15th day of September, 1947, filed with the Clerk
of the Tax Court of the United States at Washing-
ton, D. C., a petition for review by the United States
Circuit Court of Appeals for the Ninth Circuit of
the decision of the Tax Court of the United States
heretofore rendered in the above-entitled cause. A
copy of the petition for review as filed is hereto at-
tached and served upon you.

Dated: September 15, 1947.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF,

By SIDNEY H. WALL,
Attorneys for Petitioner. [241]

Personal service of the foregoing notice, together
with a copy of the petition for review mentioned
therein, is hereby acknowledged this 19th day of
September, 1947.

COMMISSIONER OF
INTERNAL REVENUE,

By /s/ CHARLES OLIPHANT,
Chief Counsel L.D.K., Bureau of Internal Revenue,
Counsel for Respondent.

[Endorsed]: T.C.U.S. Filed Sept. 25, 1947. [242]

In the United States Circuit Court of Appeals
for the Ninth Circuit

T. C. Docket No. 5042

INEZ H. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW

Now comes Inez H. Northrop, petitioner in this cause, by her attorneys, Maynard J. Toll, Sidney H. Wall and George F. Elmendorf, and petitions for a review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of The Tax Court of the United States rendered on June 18, 1947, determining a deficiency in petitioner's federal income tax for the calendar year 1940 in the amount of \$57,474.19. In support of her petition, petitioner respectfully shows:

1. VENUE

Petitioner on review (hereinafter sometimes called "petitioner") is a resident of the County of Los Angeles, State of California. Petitioner's return of federal income tax for the calendar year 1940, in respect of which the asserted liability arises, was filed with the Collector of [243] Internal Revenue for the Sixth District of California, whose office is located in Los Angeles, California, within the juris-

diction of the Circuit Court of Appeals for the Ninth Circuit.

2. NATURE OF CONTROVERSY

The controversy relates to the proper determination of the petitioner's liability for federal income taxes for the calendar year 1940. The basic questions are (a) whether or not certain stock received by petitioner's husband constituted a realization of income by petitioner (to the extent of petitioner's community one-half thereof) in 1940, and (b) if so, what was the amount thereof.

Petitioner's husband, John K. Northrop, an aeronautical engineer and aircraft designer, was one of the promoters of Northrop Aircraft, Inc. (herein called the "Company"), a California corporation organized in March, 1939, to engage in the business of designing and manufacturing aircraft and aircraft parts. The Company was authorized to issue two classes of stock, known as Class A Common and Class B Common.

On June 17, 1939, a contract was entered into between petitioner's husband and the Company by which the Company agreed, in consideration for the use of his name, his past promotional services and his agreement to be employed by the Company to take charge of engineering and design for [244] five years, to issue to petitioner's husband certain of its Class A and Class B shares on the basis of a specified ratio to the number of its Class A shares which should thereafter be sold to the public.

Pursuant to a permit issued by the California

Corporation Commissioner on June 15, 1939, the Company, from July 21, 1939, to November 28, 1939, sold and issued 250,000 of its Class A shares to underwriters for distribution to the public, receiving \$5 per share therefor. The sale of the 250,000 Class A shares by November 28, 1939, entitled petitioner's husband, under his contract with the Company, to 15,384 Class A shares and 38,461 Class B shares.

The Corporation Commissioner's permit required that all the shares to be issued to petitioner's husband pursuant to his contract should be held in escrow until released by the Commissioner, prohibited sale of any such escrowed shares without the Commissioner's consent, and required certain waivers of the rights of petitioner's husband to receive dividends and to participate in distributions of assets while the shares were held in escrow.

The Company, in June, 1939, designated the escrow holder pursuant to said permit. The Corporation Commissioner's approval of said escrow holder was sought and obtained, and the required waiver of petitioner's husband's rights with respect to dividends and assets was executed and filed, in January, 1940. The certificates representing the [245] Class A and Class B shares in question were issued in the name of petitioner's husband on March 4, 1940, and were forthwith placed in escrow pursuant to the conditions of the permit. They remained in escrow subject to such conditions until October 26, 1942, except that on November 19, 1940, one-third (or 5240) of petitioner's Class A shares were released by order of the Corporation Commissioner.

In addition to the restrictions contained in the Corporation Commissioner's permit, the Class B shares issued to petitioner's husband were, under the Company's articles of incorporation, restricted as to receipt of dividends and as to distribution of assets on liquidation, and were to become void on August 1, 1944, if no adjusted net profits were theretofore earned by the Company: they were to become convertible into Class A shares on or before August 1, 1944, only if specified earnings requirements per Class A share had been met.

Furthermore, 60% of the Class B shares issued to petitioner's husband were, under his contract with the Company, subject to an option in the Company to repurchase at 25 cents per share in certain events.

The Commissioner of Internal Revenue determined that the Class A and Class B shares issued to petitioner's husband were received by him on March 4, 1940, when the certificates representing such shares were issued and placed in escrow, and that they constituted income in that year to [246] petitioner, to the extent of her community one-half thereof, in the amount of their fair market value. The Commissioner determined that value to be \$6.25 per share for both Class A and Class B shares, a figure approximating the then current over-the-counter price for publicly held Class A shares which were subject to no restrictions or options. Petitioner contended (a) that the shares were received in 1939 when petitioner's husband's right to them accrued, and not in 1940 when the certificates representing

the shares were issued, and (b) that even if the shares were received in 1940, they had no fair market value at the time of such receipt.

3. PRIOR PROCEEDINGS

On the basis of his determination as aforesaid, the Commissioner of Internal Revenue, on or about February 24, 1944, notified petitioner of a deficiency in her Federal income tax for the calendar year 1940 in the amount of \$99,479.04. Petitioner filed in the Tax Court of the United States her petition for a redetermination of such asserted deficiency; and an answer was filed in due course by the Commissioner of Internal Revenue. The case was tried before a Division of the Tax Court in Los Angeles on November 12 and 13, 1946, after having been consolidated for purposes of hearing and briefing with the case of petitioner's husband, John K. Northrop v. Commissioner of Internal Revenue, Tax Court Docket No. 5041, and with the cases of other promoters [247] of Northrop Aircraft, Inc. (and their respective wives) who had received shares of its stock under similar circumstances.

The Division of the Tax Court held that the shares received by petitioner's husband constituted a realization of income by petitioner, to the extent of her community one-half thereof, in 1940, and that both the Class A and Class B shares so received then had a fair market value of \$4.00 per share. Petitioner moved for a review by the full Tax Court of the findings of fact and opinion of the Division of the Tax Court embodying such holding. Such mo-

tion was denied, and on June 18, 1947, a decision was entered to the effect that there was a deficiency in petitioner's income tax for the calendar year 1940 in the amount of \$57,474.19.

4.

The petitioner is aggrieved by the findings of fact and conclusions of law in the findings and opinion of the Tax Court and by its decision entered pursuant thereto, both with respect to the decision that the shares were received by petitioner's husband in 1940 rather than in 1939, and with respect to the decision that both the Class A and Class B shares had a fair market value of \$4.00 per share, or any fair market value, when the certificates therefor were issued in 1940.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF,

By SIDNEY H. HALL,
Attorneys for Petitioner.

[Endorsed]: T.C.U.S. Filed Sept. 15, 1947. [248]

[Title U. S. Court of Appeals and Cause No. 5042.]

NOTICE OF FILING PETITION FOR
REVIEW

To: Commissioner of Internal Revenue and Charles
Oliphant, Chief Counsel, Bureau of Internal
Revenue, Washington, D. C.

You Are Hereby Notified that the petitioner on
the 15th day of September, 1947, filed with the

Clerk of the Tax Court of the United States at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the petition for review as filed is hereto attached and served upon you.

Dated: September 15, 1947.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF,

By SIDNEY H. WALL,
Attorneys for Petitioner.

Personal service of the foregoing notice, together with a copy of the petition for review mentioned therein, is hereby acknowledged this 19th day of September, 1947.

COMMISSIONER OF
INTERNAL REVENUE.

By /s/ CHARLES OLIPHANT,
L.D.K.

Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent.

[Endorsed]: T.C.U.S. Filed Sept. 25, 1947.

In the Tax Court of the United States

T. C. Docket No. 5041

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STATEMENT OF POINTS

Petitioner hereby states the following points upon which he intends to rely on review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States rendered in the above-entitled cause on June 18, 1947:

1. The Tax Court erred in holding that income was received by petitioner in the calendar year 1940 by reason of the issuance in that year to petitioner of certificates representing shares of promotional stock of Northrop Aircraft, Inc.

2. The Tax Court erred in determining that all Class A and Class B shares of Northrop Aircraft, Inc., for which certificates were issued to petitioner in 1940 had a fair market value of \$4.00 per share, or any fair market value, at the time of the issuance of such certificates. [251] The Tax Court's holding to that effect is contrary to law, and its

finding to that effect is not supported by substantial or any evidence.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF.

By SIDNEY H. WALL,
Attorneys for Petitioner.

(Affidavit of Service by Mail attached.)

[Endorsed]: T.C.U.S. Filed Oct. 20, 1947. [252]

[Title of Tax Court and Cause No. 5042.]

STATEMENT OF POINTS

Petitioner hereby states the following points upon which she intends to rely on review by the United States Circuit Court of Appeals for the Ninth Circuit of decision of the Tax Court of the United States rendered in the above-entitled cause on June 18, 1947:

1. The Tax Court erred in holding that income was received by petitioner in the calendar year 1940 by reason of the issuance in that year to petitioner's husband of certificates representing shares of promotional stock of Northrop Aircraft, Inc.

2. The Tax Court erred in determining that all Class A and Class B shares of Northrop Aircraft, Inc., for which certificates were issued to petitioner's husband in 1940 had a fair market value of \$4.00 per share, or any [254] fair market value, at

the time of the issuance of such certificates. The Tax Court's holding to that effect is contrary to law, and its finding to that effect is not supported by substantial or any evidence.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF.

By SIDNEY H. WALL,
Attorneys for Petitioner.

(Affidavit of Service by Mail attached.)

[Endorsed]: T.C.U.S. Filed Oct. 20, 1947. [255]

In the United States Circuit Court of Appeals
For the Ninth Circuit

Tax Court Docket No. 5041-5042

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

APPLICATION FOR CONSOLIDATION
OF CAUSES

Now comes John K. Northrop, petitioner on review in this cause (hereinafter sometimes called "petitioner"), by his attorneys, O'Melveny & Myers, Maynard J. Toll and Sidney H. Wall, and respectfully makes application for an order of this

Honorable Court consolidating the above-entitled case with the case entitled Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5042, for the purposes of briefing and hearing on review in this Honorable Court. In support of his application, petitioner respectfully shows:

1. On September 15, 1947, petitioner filed with the clerk of the Tax Court of the United States his petition for review by this Honorable Court of the decision of the Tax Court of the United States rendered in the above-entitled case on June 18, 1947, determining a deficiency [257] in petitioner's Federal income tax for the calendar year 1940 in the amount of \$57,474.19. A copy of said petition for review, together with notice thereof, was served upon the respondent herein, the Commissioner of Internal Revenue, by registered mail on September 16, 1947.

2. On said date of September 15, 1947, petitioner's wife, Inez H. Northrop, likewise filed with the clerk of the Tax Court of the United States her petition for review by this Honorable Court of the decision of the Tax Court of the United States rendered on June 18, 1947, in the case entitled Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5042, determining a deficiency in the Federal income tax of said Inez H. Northrop for the calendar year 1940 in the amount of \$57,474.19. A a copy of said petition for review, together with notice thereof, was likewise served upon the respondent herein, the

Commissioner of Internal Revenue, by registered mail on September 16, 1947.

3. The aforesaid cases of petitioner herein and of his wife, Inez H. Northrop, involve identical questions of law and are based upon identical facts. The basic questions in both said cases are (a) whether or not certain stock received by petitioner herein constituted a realization of income by petitioner and his wife, Inez H. Northrop, in 1940 (each to the extent of one-half thereof as his or her community property); and (b) if so, [258] what was the amount of such income. Said two cases of petitioner herein and of his said wife, Inez H. Northrop, were consolidated for purposes of hearing and briefing before the Tax Court of the United States, together with six other cases involving similar facts and similar questions of law.* The cases of petitioner herein and of his said wife, Inez H. Northrop,

*The other six cases mentioned are: Lamotte T. Cohu, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5039; Didi M. Cohu, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5040; Gage H. Irving, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5043; Eleanor Salisbury Irving, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5044; Edward A. Bellande and Molly LaMont Bellande, Petitioners, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5045; and Moye W. Stephens and Inez B. Stephens, Petitioners, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5046.

together with the other six cases referred to above, were heard and decided in the Tax Court on the basis of a single stipulation of facts and of certain oral testimony introduced on behalf of all petitioners. No review of the decisions of the Tax Court of the United States in said six other cases is being sought by the petitioners therein.

4. By reason of the foregoing circumstances, petitioner believes that the time of this Honorable Court will be conserved by consolidation of this case with that of petitioner's wife, Inez H. Northrop, for purposes of briefing and hearing on review in this Court on the basis of a single consolidated record on review, and that such [259] consolidation will be to the best interests of all parties concerned.

5. A similar application for consolidation of this case and that of petitioner's wife, Inez H. Northrop, is being filed concurrently herewith by said Inez H. Northrop in said case entitled *Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent*, Tax Court Docket No. 5042.

Wherefore, petitioner prays that this Honorable Court enter its order that this case be consolidated with the case entitled *Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent*, Tax Court Docket No. 5042, for purposes of briefing and hearing on review in this Honorable Court on the basis of a single consolidated record on review, and that the clerk of the Tax Court of the United States be directed to prepare and transmit

to this Court a single consolidated record on review in said two cases.

Respectfully submitted,

O'MELVENY & MYERS,
MAYNARD J. TOLL, and
SIDNEY H. WALL.

By /s/ SIDNEY H. WALL,
Attorneys for Petitioner.

So Ordered:

WILLIAM DENMAN,
Acting Senior United States
Circuit Judge.

Attest: Sept. 23, 1947.

A true copy.

/s/ PAUL P. O'BRIEN.
Clerk.

[Endorsed]: Filed Sept. 23, 1947. Paul P. O'Brien,
Clerk.

State of California,
County of Los Angeles—ss.

Harley Walther, being first duly sworn, deposes and says:

That affiant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of Los Angeles, over the age of eighteen (18) years, and not a party to or interested in the within action; that affiant's business address is 900 Title Insurance Building, 433 South Spring Street, Los Angeles 13, California;

That on September 20, 1947, affiant served the within Application for Consolidation of Causes

upon counsel named below by depositing a true copy thereof in a United States mail box at Los Angeles, California, in a sealed envelope, registered, with postage thereon fully prepaid and addressed as follows: Charles Oliphant, Esq., Chief Counsel, Bureau of Internal Revenue, Washington, D. C.

That there is a regular communication by mail between the place of mailing and the place so addressed.

HARLEY WALTHER.

Subscribed and sworn to before me this 20th day of September, 1947.

[Seal] AGNES E. SHULTZ,
Notary Public in and for said County and State.

[Endorsed]: T.C.U.S. Sept. 29, 1948. [261]

[Title of U. S. Court of Appeals and Cause.]

APPLICATION FOR TRANSMITTAL OF
ORIGINAL EXHIBITS FROM
TAX COURT

Now comes John K. Northrop, petitioner on review in this cause (hereinafter sometimes called "petitioner"), by his attorneys, O'Melveny & Myers, Maynard J. Toll and Sidney H. Wall, and respectfully makes application to this Honorable Court for an order that, upon designation of the contents of the record on review herein, the original exhibits on file with the Tax Court of the United States in this case be transmitted by the clerk of the Tax Court to this Honorable Court for its inspection. In support of his application, petitioner respectfully shows:

1. On September 15, 1947, petitioner filed with the clerk of the Tax Court of the United States his petition for review by this Honorable Court of the decision of the Tax Court of the United States rendered in this case on June 18, 1947, determining a deficiency in petitioner's Federal income tax for the calendar year 1940 in the amount of \$57,-174.19. A copy of said petition for review, together with notice thereof, was served upon the respondent herein, the Commissioner of Internal Revenue, by registered mail on September 16, 1947.

2. Concurrently herewith, petitioner has filed in this Honorable Court his application for consolidation of this case with the case entitled Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5042, for purposes of briefing and hearing on review in this Court, and for an order directing the clerk of the Tax Court of the United States to prepare and transmit to this Court a single consolidated record on review in said two cases.

3. There are twenty-nine (29) exhibits on file with the Tax Court of the United States in connection with this case. Certain of said exhibits are in the form of printed documents, or photostatic copies of printed documents, consisting of the following:

A 16-page prospectus issued in connection with the offering for sale of certain stock (Exhibit 1-A);

The articles of incorporation of Northrop [263] Aircraft, Inc. (Exhibit 2-B);

Certain contracts between Northrop Aircraft, Inc., and John K. Northrop and other promoters of that corporation (Exhibits 3-C, 4-D, 5-E, 6-F, 7-G and 8-H);

Certain ledger accounts (Exhibit 20-W); and

Two 13-page annual reports to the stockholders of Northrop Aircraft, Inc., including financial statements and charts (Exhibits BB and CC).

The remaining exhibits consist of typewritten copies of the following material:

Various compilations of figures and financial statements (Exhibits 9-I, 18-S, T, 19-U and V);

Certain rules and regulations of the California Division of Corporations (Exhibit 10-J);

Certain corporate resolutions (Exhibit 11-K);

A certain agreement (Exhibit 16-P);

Applications to the California Commissioner of Corporations (Exhibits R and 21-X);

A decision of the California Commissioner of Corporations (Exhibit 24-AA); and

Various letters (Exhibits 12-L, 13-M, 14-N, 15-O, 17-Q, 22-Y and 23-Z).

4. If the original exhibits on file in the Tax [264] Court of the United States are permitted to be transmitted to this Court for inspection as a part of the record on review in this case, the expense to petitioner of having a typewritten copy of the record on review prepared by the Clerk of the Tax Court of the United States will be materially reduced; and petitioner believes that the transmission to this Court, for its inspection, of the original ex-

hibits on file with the Tax Court, particularly in the case of the exhibits which are in the form of printed documents or photostatic copies of printed documents, will better serve the convenience of this Court than would the transmission of typewritten copies thereof prepared by the clerk of the Tax Court.

5. A similar application for permission to transmit original exhibits is being filed concurrently herewith by petitioner's wife, Inez H. Northrop, in the case entitled Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5042.

Wherefore, petitioner prays that this Honorable Court enter its order directing the clerk of the Tax Court, upon designation of the contents of the record on review herein,

(a) to transmit all the original exhibits in this case to this Court for its inspection as a part of the record on review in this case, or as a part of [265] the consolidated record on review in this case and in the case of Inez H. Northrop, Petitioner, v. Commissioner of Internal Revenue, Respondent, Tax Court Docket No. 5042, in the event that the petitions for consolidation filed herein and in said case shall be granted, or

(b) in the alternative and in the event that this Court shall determine that all the original exhibits on file in the Tax Court should not be so transmitted, then to transmit to this Court for its inspection as a part of the record on review herein as aforesaid the originals on file with the Tax Court

of Exhibits 1-A, 2-B, 3-C, 4-D, 5-E, 6-F, 7-G, 8-H, 20-W, BB and CC, being the exhibits in the form of printed documents or photostatic copies of printed documents hereinabove referred to.

Respectfully submitted,

O'MELVENY & MYERS,
MAYNARD J. TOLL, and
SIDNEY H. WALL.

By SIDNEY H. WALL,
Attorneys for Plaintiff.

Ordered application granted in accordance with prayer of Subdivision (a) of the foregoing application.

WILLIAM DENMAN,
United States Circuit Judge.

A true copy.

Attest: Sept. 23, 1947, Paul P. O'Brien, Clerk.

[Endorsed]: Filed September 23, 1947. Paul P. O'Brien, Clerk. [266]

State of California,
County of Los Angeles—ss.

Harley Walther, being first duly sworn, deposes and says:

That affiant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of Los Angeles, over the age of eighteen (18) years, and not a party to or interested in the within action; that affiant's business address is 900 Title Insurance Building, 433 South Spring Street, Los Angeles 13, California;

That on September 20, 1947, affiant served the within Application for Transmittal of Original Exhibits from Tax Court upon counsel named below by depositing a true copy thereof in a United States mail box at Los Angeles, California, in a sealed envelope, registered, with postage thereon fully prepaid and addressed as follows: Charles Oliphant, Esq., Chief Counsel, Bureau of Internal Revenue, Washington, D. C.

That there is a regular communication by mail between the place of mailing and the place so addressed.

HARLEY WALTHER.

Subscribed and sworn to before me this 20th day of September, 1947.

(Seal) AGNES E. SHULTZ,
Notary Public in and for Said County and State.

[Endorsed]: T.C.U.S. Filed Sept. 29, 1947. [267]

In the Tax Court of the United States

T. C. Docket No. 5041

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review heretofore filed by the petitioner:

1. The docket entries of all proceedings before the Tax Court.

2. Pleadings before the Tax Court, as follows:
(a) Petition, (b) Answer.

3. The findings of fact and opinion of the Tax Court.

4. The motion for review by the full Tax Court.

5. The decision of the Tax Court. [268]

6. The stipulation of facts, together with all exhibits attached thereto, as well as Exhibits BB and CC on file.

7. From the official transcript of oral testimony,

pages 4 and 5, containing the consolidation of this case and others for hearing in the Tax Court, pages 27 to 30, inclusive, containing petitioner's objections to certain evidence, the testimony of Mr. Claude M. Monson appearing on pages 30 to 79, inclusive, the testimony of Mr. Carl L. Barnes, appearing on pages 80 to 86, inclusive; the testimony of Mr. B. P. Lester, appearing on pages 88 to 137, inclusive; the testimony of Mr. Henry M. Bateman appearing on pages 138 to 159, inclusive, and the testimony of Mr. Justus A. Hahn, appearing on pages 163 to 165, inclusive.

8. The petition for review filed on September 15, 1947.

9. The notice of filing of petition for review.

10. This designation of contents of record on review.

11. The statement of points filed herewith.

Two copies of all the portions of said official transcript designated in item 7 above are filed herewith.

The above-entitled cause having been consolidated for hearing in the Tax Court with the case entitled *Inez H. Northrop v. Commissioner of Internal Revenue*, Docket No. [269] 5042, and with six other cases (Docket Nos. 5039, 5040, 5043, 5044, 5045 and 5046), and the United States Circuit Court of Appeals for the Ninth Circuit having granted petitioner's application for consolidation of the above-entitled cause with said case of *Inez H. Northrop*, Docket No. 5042, for purposes of briefing and hearing on review on the basis of a single consolidated

record on review, you will please prepare and transmit a single consolidated record on review in said two cases in which items 3, 4, 6 and 7 referred to in the preceding paragraph are not duplicated.

Said United States Circuit Court of Appeals for the Ninth Circuit having granted petitioner's application for transmission of all original exhibits in this case to said Circuit Court of Appeals for its inspection as a part of the consolidated record on review in said two cases mentioned above, you will please transmit all said original exhibits in compliance with the directions of said Circuit Court of Appeals.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF.

By SIDNEY H. WALL,
Attorneys for Petitioner.

(Affidavit of Service by Mail attached.)

[Endorsed]: T.C.U.S. Filed Oct. 20, 1947. [270]

[Title of Tax Court and Cause No. 5042.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review heretofore filed by the petitioner:

1. The docket entries of all proceedings before the Tax Court.

2. Pleadings before the Tax Court, as follows:
(a) Petition; (b) Answer.

3. The findings of fact and opinion of the Tax Court.

4. The motion for review by the full Tax Court.

5. The decision of the Tax Court. [272]

6. The stipulation of facts, together with all exhibits attached thereto, as well as Exhibits BB and CC on file.

7. From the official transcript of oral testimony, pages 4 and 5, containing the consolidation of this case and others for hearing in the Tax Court; pages 27 to 30, inclusive, containing petitioner's objections to certain evidence; the testimony of Mr. Claude M. Monson, appearing on pages 30 to 79, inclusive; the testimony of Mr. Carl L. Barnes appearing on pages 80 to 86, inclusive; the testimony of Mr. B. P. Lester, appearing on pages 88 to 137, inclusive; the testimony of Mr. Henry M. Bateman, appearing on pages 138 to 159, inclusive, and the testimony of Mr. Justus A. Hahn, appearing on pages 163 to 165, inclusive.

8. The petition for review filed on September 15, 1947.

9. The notice of filing of petition for review.

10. This designation of contents of record on review.

11. The statement of points filed herewith.

Two copies of all the portions of said official transcript designated in item 7 above are filed herewith.

The above-entitled cause having been consolidated for hearing in the Tax Court with the case entitled *John K. Northrop v. Commissioner of Internal Revenue*, Docket No. [273] 5041, and with six other cases (Docket Nos. 5039, 5040, 5043, 5044, 5045 and 5046), and the United States Circuit Court of Appeals for the Ninth Circuit having granted petitioner's application for consolidation of the above-entitled cause with said case of *John K. Northrop*, Docket No. 5041, for purposes of briefing and hearing on review on the basis of a single consolidated record on review, you will please prepare and transmit a single consolidated record on review in said two cases in which items 3, 4, 6 and 7 referred to in the preceding paragraph are not duplicated.

Said United States Circuit Court of Appeals for the Ninth Circuit having granted petitioner's application for transmission of all original exhibits in this case to said Circuit Court of Appeals for its inspection as a part of the consolidated record on review in said two cases mentioned above, you will please transmit all said original exhibits in compliance with the directions of said Circuit Court of Appeals.

MAYNARD J. TOLL,
SIDNEY H. WALL, and
GEORGE F. ELMENDORF,

By SIDNEY H. WALL,
Attorneys for Petitioner.

(Affidavit of Service by Mail attached.)

[Endorsed]: T.C.U.S. Filed Oct. 20, 1947. [274]

[Title of Tax Court and Cause Nos. 5041-42.]

CERTIFICATE

I, Victor S. Mersch, Clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 275, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 2nd day of November, 1947.

(Seal) /s/ VICTOR S. MERSCH,
Clerk, The Tax Court of the United States.

[Endorsed]: No. 11787. United States Circuit Court of Appeals for the Ninth Circuit. John K. Northrop, Petitioner, vs. Commissioner of Internal Revenue, Respondent, and Inez H. Northrop, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petitions to Review Decisions of The Tax Court of the United States.

Filed November 15, 1947.

 /s/ PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

Docket No. 5041

JOHN K. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 5042

INEZ H. NORTHROP,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

APPLICATION FOR EXTENSION OF TIME
FOR TRANSMITTING RECORD ON
REVIEW

John K. Northrop and Inez H. Northrop, petitioners on review in the above-entitled causes (hereinafter sometimes called "Petitioners"), by their attorneys O'Melveny & Myers, Maynard J. Toll and Sidney H. Wall, respectfully make application to this Honorable Court for an extension of the time for transmission of the record on review in the above-entitled causes by the clerk of the Tax Court of the United States to the clerk of this Honorable Court for a period of thirty (30) days from and after October 25, 1947. In support of their application, Petitioners respectfully show:

1. On September 15, 1947, Petitioners and each of them filed with the clerk of the Tax Court of the United States their separate petitions for review by this Honorable Court of the decision of the Tax Court rendered in the above-entitled cases on June 18, 1947, determining deficiencies in Petitioners' Federal income taxes for the calendar year 1940. A copy of each of said petitions for review, together with notice thereof was served upon the respondent the Commissioner of Internal Revenue by registered mail on September 16, 1947.

2. On September 23, 1947, pursuant to applications therefor filed by Petitioners, this Honorable Court entered its order that the two above-entitled cases be consolidated for purposes of briefing and hearing on review in this Honorable Court on the basis of a single consolidated record on review, and that the clerk of the Tax Court of the United States be directed to prepare and transmit to this Court a single consolidated record on review in said two cases.

3. The grounds upon which this application for extension of time for transmitting record on review is bases are set forth in the affidavit of Sidney H. Wall attached hereto marked Exhibit A and by this reference made a part hereof as if herein set out in full.

Wherefore, Petitioner pray that the time for transmission of the record on review in the above-entitled cases by the clerk of the Tax Court of the United States to the clerk of this Honorable Court

be extended for a period of thirty (30) days from and after October 25, 1947.

Respectfully submitted,

O'MELVENY & MYERS,
MAYNARD J. TOLL and
SIDNEY H. WALL,
By SIDNEY H. WALL,
Attorneys for Petitioners.

So Ordered:

WILLIAM DENMAN,
Acting Senior United States Circuit Judge.

October 25, 1947.

[Endorsed]: Filed Oct. 25, 1947. Paul P. O'Brien,
Clerk.

A True Copy. Attest: Oct. 25, 1947.

(Seal) /s/ PAUL P. O'BRIEN,
Clerk.

[Title of U. S. Court of Appeals and Causes.]

STATEMENT OF POINTS

Petitioners on review in the above-entitled cases (hereinafter sometimes called "Petitioners'") hereby state the following points upon which they intend to rely on review by the above-entitled Court of the decisions of the Tax Court of the United States rendered in the above-entitled cases on June 18, 1947:

1. The Tax Court erred in holding that income

was received by Petitioners, or either of them, in the calendar year 1940 by reason of the issuance in that year to Petitioner John K. Northrop of certificates representing shares of promotional stock of Northrop Aircraft, Inc., a corporation. The Tax Court's holding to that effect is contrary to law, and its finding to that effect is not supported by substantial or any evidence.

2. The Tax Court erred in determining that the Class A and Class B shares of Northrop Aircraft, Inc., for which certificates were issued to Petitioner John K. Northrop in 1940 had a fair market value of \$4.00 per share, or any fair market value, at the time of the issuance of such certificates. The Tax Court's holding to that effect is contrary to law, and its finding to that effect is not supported by substantial or any evidence.

O'MELVENY & MYERS,
MAYNARD J. TOLL and
SIDNEY H. WALL,

By /s/ SIDNEY H. WALL,
Attorneys for Petitioners.

(Affidavit of Service by Mail attached.)

[Endorsed]: Filed November 24, 1947. Paul P. O'Brien, Clerk.

[Title of U. S. Court of Appeals and Causes.]

DESIGNATION OF RECORD ON REVIEW

To The Honorable Paul P. O'Brien, Clerk of the
United States Circuit Court of Appeals for the
Ninth Circuit.

Petitioners on review in the above-entitled cases hereby designate the following portions of the record in said cases heretofore certified by the clerk of the Tax Court of the United States, which said Petitioners consider necessary for the consideration of their Petitions for Review of the decisions of the Tax Court of the United States rendered in the above-entitled cases:

1. Docket entries of all proceedings before the Tax Court in T.C. Docket No. 5041 (Cert. Rec. p. 1).*
2. Docket entries of all proceedings before the Tax Court in T.C. Docket No. 5042 (Cert. Rec. p. 3).
3. Petition in T.C. Docket No. 5041 (Cert. Rec. p. 5).
4. Answer in T.C. Docket No. 5041 (Cert. Rec. p. 17).
5. Petition in T.C. Docket No. 5042 (Cert. Rec. p. 19).
6. Answer in T.C. Docket No. 5042 (Cert. Rec. p. 31).

* Page references are to the certified record heretofore transmitted by the clerk of the Tax Court of the United States.

7. Findings of Fact and Opinion of the Tax Court (both dockets) (Cert. Rec. p. 33).

8. Motion for Review by the full Tax Court (both dockets) (Cert. Rec. p. 55).

9. Decision of the Tax Court in T.C. Docket No. 5041 (Cert. Rec. p. 65).

10. Decision of the Tax Court in T.C. Docket No. 5042 (Cert. Rec. p. 66).

11. Stipulation of Facts (both dockets) (Cert. Rec. p. 67), together with Exhibits 1-A to 17-Q, inclusive, R, 18-S, T, 19-U, V, 20-W to 23-Z, inclusive, and 24-AA, all of which are attached to said Stipulation of Facts, as well as Exhibits BB and CC (all of which original exhibits were transmitted by the clerk of the Tax Court in compliance with an order of the United States Circuit Court of Appeals for the Ninth Circuit).

12. Excerpts from official transcript of oral testimony (both dockets) (Cert. Rec. p. 88) as follows: pages 4 and 5 of said official transcript, pages 27 to 30 thereof, inclusive, the testimony of Mr. Claude M. Monson appearing on pages 30 to 79 thereof, inclusive, the testimony of Mr. Carl L. Barnes appearing on pages 80 to 86 thereof, inclusive, the testimony of Mr. B. P. Lester appearing on pages 88 to 137 thereof, inclusive, the testimony of Mr. Henry M. Bateman appearing on pages 138 to 159 thereof, inclusive, and the testimony of Mr. Justus A. Hahn appearing on pages 163 to 165 thereof, inclusive.

13. Petition for Review and Notice of Filing thereof with Proof of Service in T.C. Docket No. 5041 (Cert. Rec. p. 234).

14. Petition for Review and Notice of Filing thereof with Proof of Service in T.C. Docket No. 5042 (Cert. Rec. p. 243).

15. Statement of Points in T.C. Docket No. 5041 (Cert. Rec. p. 251).

16. Statement of Points in T.C. Docket No. 5042 (Cert. Rec. p. 254).

17. Application and Order for Consolidation of Causes (both dockets) (Cert. Rec. p. 257).

18. Application and Order for Transmittal of Original Exhibits (both dockets) (Cert. Rec. p. 262).

19. Designation of Contents of Record on Review in T.C. Docket No. 5041 (Cert. Rec. p. 268).

20. Designation of Contents of Record on Review in T.C. Docket No. 5042 (Cert. Rec. p. 272).

21. Application and Order of this Court for extension of time for transmitting record on review (not included in record certified by clerk of the Tax Court).

22. This Designation of Record on Review.

23. The Statement of Points filed herewith.

O'MELVENY & MYERS,
MAYNARD J. TOLL and
SIDNEY H. WALL,

By /s/ SIDNEY H. WALL,
Attorneys for Petitioners.

(Affidavit of Service by Mail attached.)

[Endorsed]: Filed November 24, 1947. Paul P. O'Brien, Clerk.

At a Stated Term, to wit: The October Term, 1948, of the United States Court of Appeals for the Ninth Circuit, held in the Court Room thereof, in the City and County of San Francisco, in the State of California, on Tuesday, the fourth day of January, in the year of our Lord one thousand nine hundred and forty-nine.

Present: Honorable William Healy, Circuit Judge, Presiding, Honorable Homer T. Bone, Circuit Judge, Honorable William E. Orr, Circuit Judge.

[Title of Cause.]

ORDER GRANTING APPLICATION FOR
CONSIDERATION OF ORIGINAL
EXHIBITS

Upon consideration of the application of the petitioners that the original exhibits transmitted to this Court by the clerk of the Tax Court of the United States be considered by this Court in their original form without printing, and good cause therefor appearing, It Is Ordered that such application be, and hereby is granted.

